United States Court of Appeals

for the Second Circuit

JOINT APPENDIX

76-7607

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket Nos. 76-7607, 76-7619

UNIVERSITY HILL FOUNDATION,
Plaintiff-Appellee and Cross-Appellant,

—against—

GOLDMAN, SACHS & CO.,
Defendant-Appellant and Cross-Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK
(71 CIV. 1166 (MEL))

UNITED STATES COURT OF APPEALS
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SECOND CIRCUIT

JOINT APPENDIX

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investor had to stand on its own feet. It was not with the view of any other business.

Q Can you state what you mean when you say that any issuer has to "stand on its own feet"?

A It had to be credit worthy in our opinion.

Q Are you competent to grant an opinion on credit worthiness?

A I am not.

Q Were you competent to grant an opinion on the credit worthiness of Penn Central?

A I was not.

Q So that at no time during 1968, 1969 and 1970 did you personally have an opinion formed on your own as to the credit worthiness of Penn Central, is that correct?

A I relied solely on the judgment of Wilson and his men, Vogel, Van Cleave and they had the right to buy or not to buy or to issue or to sell and not to sell.

Q You exercised no judgment whatsoever with respect to the credit worthiness of Penn Central?

A I relied solely on their judgment.

Q In the memorandum from John Whitehead

"Mr. Berkowitz: What do you have indirectly?

"The Witness: Except when problems arise, I get in them, on them and in the contact that I have with the Paper Department is when my clients, my business contacts, issue commercial paper, I usually want to know what is going on. But I have no day-to-day relationship with them whatsoever."

Were you asked those questions and did you give those answers?

A Yes.

Q Was Penn Central one of the business contacts as to which you wanted to know what was going on?

A I have told you that a lot of times already. Yes.

Q Was it also one as to which there were problems?

A Yes.

Q Can you state the nature of those problems?

A The problems were that we wanted them to get 100 per cent bank-line coverage and we only had 50 per cent and the problem was the paper was not moving very fast. Those were the primary problems.

Q Were there any other problems?

A Those were the principal ones.

Q Do you know why the paper was not moving very fast?

A It wasn't moving very fast because of the publicity regarding the earnings which were in all the papers and in the Wall Street Journal, which everyone knew about.

Q Mr. Levy, at what point in time did you ask Penn Central to get 100 per cent bank line coverage?

A I will have to refresh my memory if I may. I believe it was when we had lunch with Dave Bevan on February 6th and O'Herron and Loder.

Q Did they tell you that they were unable to get an additional $100 million in bank lines to increase their coverage to 100 per cent coverage?

A I will have to refresh my memory here, if I may. Yes, they did.

Q At what point in time?

A At lunch on February the 6th.

Q Was the request by Goldman, Sachs & Co. to Penn Central to increase its bank lines to 100 per cent coverage a matter of public record or was that non-public information?

A I don't believe that we put it in the papers.

you were receiving in these memoranda was important information?

A I did.

Q Did you think that the information about the bank line coverage was important?

MR. SCHWARTZ: I object to the form of the question. Important to whom. For what purpose?

You may answer, if you know.

A It was information that I would have liked to have had.

Q If you were buying the paper?

A I told you before, Mr. Pollack, I have never been in the position -- on the other side of the fence of an institutional buyer. I don't know how an institutional buyer would feel.

Q In what sense was the information that you would have liked to have?

A I don't know.

Q You testified that it was information that you would like to have.

Can you explain what you mean by your statement?

A As a partner of Goldman, Sachs & Co. and

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A It was one of many considerations in our decision to sell commercial paper.

Q Can you state what you mean when you say it was one of many considerations?

A The fact of the losses was one of many considerations.

Q What were some of the others?

A In a short term note our interest is to try to see that it is paid on maturity and what other assets to look to besides earning power. Notes are not paid out of earning power, they are paid out of cash and the ability to acquire cash and we thought they had the ability to acquire the cash.

Q In terms of commercial paper, is the cash position of the issuer important?

A Its present and future and potential cash availability is important and we thought they had plenty of assets from which to derive the cash to meet the commercial paper.

Q In the context of commercial paper are bank lines important?

A Yes. It's another one of the many considerations.

Q In the context of commercial paper are

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earnings important?

A It's one of many considerations.

Q In the context of commercial paper is the liquidity of assets important?

A It's one of many considerations.

Q In the context of commercial paper is an inventory limit important?

MR. SCHWARTZ: I object to the form of the question. I don't understand it.

THE WITNESS: I don't understand it, either.

Q In the context of commercial paper, is the working capital position of the issuer important?

A It's one of many considerations.

Q In the context of commercial paper, is the ability of an issuer to do financing important?

A It's one of many considerations.

Q Are there other considerations other than the ones that we have just mentioned?

A Availability of assets, cash flow are many considerations. Again, I am not an expert on commercial paper. I want to make it as plain as I told you before. I relied on Wilson's sole judgment on whether or not to issue the notes. It was his final

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decision.

Q Is the encumberance of assets important?

A What does that mean?

Q Do you know what encumberance of assets means?

A You mean whether somebody else has got a lien on them?

Q Yes.

A That is one of many considerations.

Q It is an important factor?

A I didn't say that. I said it is one of many considerations.

Q So that the net of all of this is that all of the information in the blue sheets about Penn Central was important?

A I don't know anything about blue sheets. I told you I only received white sheets.

MR. SCHWARTZ: I object to the form of the question.

Q The information which you received in the credit memoranda was important information in assessing whether to continue to handle the commercial paper of Penn Central, is that correct?

MR. SCHWARTZ: That is not what the

Deposition Testimony of Roger M. Lynch

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commercial paper of any other issuer?

A Not that I recall.

Q Were you ever given a limitation on the amount of commercial paper you could purchase for inventory from any other issuer?

A A specific amount?

Q Yes.

A Not to my knowledge.

Q Penn Central was the only one on which you were given a limitation as to the amount you could buy for inventory, is that correct?

A In relation to a specific amount, that is correct. to the best of my recollection

MR. MANEY: Let's take a couple of minutes.

(Recess.)

BY MR. POLLACK:

Q Mr. Lynch, does P-32 contain any information about bank lines?

A Not that I can decipher, no.

Q Does P-32 contain any information about credit facilities at banks?

A Not that I can see.

Q Are those account sheets other than P-32

Deposition Testimony of William C. Stutt

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WILLIAM C. STUTT, called as a witness, being first duly sworn by the Notary Public, testified as follows:

BY MR. POLLACK:

Q Mr. Stutt, what is your home address?

A 118 Joralemon Street.

Q Are you employed by Goldman Sachs & Co.?

A Yes.

Q How long have you been employed with Goldman Sachs & Co.?

A Over 15 years.

Q What capacity?

A Corporate finance.

Q Are you presently an officer of Goldman Sachs & Co.?

A Yes.

Q Are you a vice president?

A Yes.

Q Were you employed by Goldman Sachs & Co. in any other capacity at any time?

A No.

MR. MANEY: I think we should make it clear we are talking about an officorial title of a partnership.

Q In the capacity of a member of the Corporate

Finance Department, what are your duties?

A I handle client relations in certain geographic areas.

Q Can you elaborate somewhat on what you mean by handling client relations?

A Endeavoring to provide a complete range of our investment banking services to our various clients and to open up new client relations.

Q Do your duties include the solicitation of new business?

A Yes.

Q Do your duties include the solicitation of additional types of business from existing clients?

A Yes.

Q Do those two functions comprise a major portion of your work?

A Are you talking about new clients?

Q The solicitation of business both from new and existing clients.

A That is the major portion, yes.

Q In the period 1968 through 1970, were you assigned to a single region of the United States?

A To two regions.

Q Can you identify those regions?

A The southeastern part of the country -

Virginia down through Florida - and the eastern part of Michigan.

Q Was there overlapping coverage of the southeast at that time by Goldman Sachs & Co.?

A How do you mean?

Q Was there anyone else in the Corporate Finance Department other than you assigned to this function in the southeast, assigned to perform this function in the southeast?

A Understand, that the people from our Philadelphia Office solicit securities business in that area and from corporations. Our Commercial Paper Department is active with the sales of paper in that area. Those men solicit business, too, at the same time.

Now we have another man that is also doing pretty much what I do in that area.

Q Who is that?

A Jack Gray, and whether he was aboard then or not, I don't know.

Q Was there any coordination of your activities with those of either the Commercial Paper Department or the Philadelphia office in the period 1968 to 1970?

A Yes. We tried to keep each other informed of what we were doing.

discussion.

MR. POLLACK: I will assume Mr. Stein will want to follow up on what you said to him, so I won't cover that subject.

Q Did you have access to the credit files on Penn Central at Goldman Sachs & Co.?

A I could have gotten the file through the Credit Department presumably.

Q On the subject of what investors wanted to know about commercial paper, was one of the important things bank lines of credit?

A This comes up in the conversation, sure, with some investors. It is not an everyday thing.

Q Is another thing that most investors want to know the NCO rating of the commercial paper?

A This comes up.

Q Is another thing the recent earnings picture?

A Not so much. It is a short-term obligation that you are buying.

Q Can you think of anything else that investors in general want to know about commercial paper which they buy?

A Denominations available, place of payment.

Q Is there anything about the company which they

would want to know in general.

A Balance sheet, income statement.

Q Debt equity ratio?

A That would be in the balance sheet.

Q Current ratio?

A No one asked those specific questions.

Q Cash flow?

A I have never been asked that.

Q Do the customers of Goldman Sachs & Co. ever ask the view of Goldman Sachs & Co. about the issuer?

A Bill Diederich did in his letter.

Q Did that happen on other occasions to you where customers wanted to know what Goldman Sachs & Co. thought of the issuer whose paper it was offering to them?

A No. Is it a prime name or isn't it a prime name. Those questions come up.

MR. POLLACK: I have no further questions of this witness subject to the recall provision, but I note that Mr. Stein is here and has questions and perhaps I will turn the floor over to him.

EXAMINATION BY MR. STEIN:

Q Mr. Stutt, did you call on Landmark from

1962 to 1969?

A Yes.

Q Sporadically?

A Yes.

Q '62 was the earliest date, was it not?

A I don't remember specifically, but I would imagine this is a pretty good estimate.

Q Is it a fair statement that what you discussed when you called on Landmark was, No. 1, trying to induce them to invest surplus funds in commercial paper, and No. 2, purchase that paper from Goldman Sachs & Co.?

A No. My objective in calling on Landmark was to establish an investment banking relationship with the idea of a public offering. Commercial paper was a very low key type of service in my objectives.

Q That was your objective --

MR. MANEY: Let Mr. Stutt finish the answer.

A (continuing) -- in my objectives of doing business with Landmark.

So, in conversations I had with Bill Diederich I was mainly interested in how he was thinking about their prospects for long-term financing, the possibility of a public offering.

Deposition Testimony of Matthew Tolan

Pages 3-5
Pages 29-31

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MATTHEW TOLAN, having been first duly sworn, was examined and testified as follows:

EXAMINATION BY

MR. POLLACK:

Q Mr. Tolan, are you employed by Goldman, Sachs & Co.?

A Yes, sir.

Q How long have you been employed by Goldman, Sachs & Co.?

A Approximately six and a half years.

Q In what capacity are you employed by Goldman, Sachs & Co.?

A At the present time?

Q Yes.

A I am Vice President, Commercial Paper Department, and also National Sales Manager of the Commercial Paper Department.

Q For how long have you served in that capacity?

A National Sales Manager since May of 1969. As Vice President of the Commercial Paper Department, January 1st, 1971.

Q Are your duties in those two positions

different?

A No.

Q In other words, you have one set of duties and the vice presidency is an additional title in the nature of a promotion?

A Correct.

Q What are your duties?

A My duties as National Sales Manager are to analyze the sales throughout the entire Commercial Paper Department by territory, by state, by geographical region, by salesman, profitability of sales, profitability of accounts, accounts-- prospective accounts that the salesmen are calling on, active accounts that the salesmen are calling on, supervision-- working with and supervising the sales managers and the salesmen, working on budgets for the Department and so on.

Basically those are my main responsibilities.

Q To whom do you report?

A To both Bob Wilson and George Van Cleave, partners of our Department.

Q Do all of the salesmen report to you?

A The salesmen report directly to the sales managers who in turn report directly to me.

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Q Who are the sales managers?

A At the present time?

Q Yes.

A At the present time -- is this going back prior to June 30th--

MR. MANEY: Right today.

A Right today, in New York, Michael Bruno. In Boston, Ted Waldron.

In Chicago, Thornton Swisher.

In St. Louis, Bob Marro.

In Los Angeles, Steve Clark.

In San Francisco, Carl Frederickson.

Q How many commercial paper salesmen are there in the Commercial Paper Department?

A I believe at the present time we have 24 salesmen and three trainees.

Q How many salesmen were there in 1968?

A I don't recall. I think-- I don't recall the actual number.

Q How many salesman were there in 1969?

A Again, I don't recall the actual number but I believe it is in the area of 23 to 26.

Q How many salesmen were there in 1970?

A Same, about 24, 25.

in here? Well, what I meant by this was that I was not aware that the Commercial Paper Department had recommended that we incorporate. But I remember, you know writing this but I didn't remember that. But I think I had this confused.

Q Do you now remember that the Commercial Paper Department did recommend to the Management Committee that the Credit Department be incorporated?

A No. If that recommendation was made, I was not part of making that recommendation, except that paragraph that is stated there.

Q Do you recall that in doing this study there was discussion of the fact that incorporation would not be as necessary if Goldman, Sachs & Co. carries virtually no inventory?

A Yes.

Q The reason why incorporation would not be necessary under that circumstance is that the risk to Goldman, Sachs & Co. would be minimized, is that correct?

A No, I believe the reason was that there was only so much money Goldman, Sachs & Co. could borrow under the -- I forget, it was either 15

or 20 we can borrow or our equity, 15 or 20 times, and if our inventories are going up to astronomical figures of 250, 300 million or more, it will not permit other areas of the firm to do possibly what they need to do who require financing.

Q Does Goldman, Sachs & Co. ever initiate distressed selling of commercial paper?

MR. MANEY: Would you describe "distressed" as you are using it?

Q Do you know what the phrase means, Mr. Tolan?

A Distress selling to me is when our inventory positions were high we would mark up the rate on the inventory.

Q Does Goldman, Sachs & Co. ever engage in distess selling of commercial paper?

A Yes.

Q What is the purpose of distress selling?

A If -- to reduce our inventory positions.

Q Did Goldman, Sachs & Co. ever engage in distress selling of the commercial paper of Penn Central Transportation Company?

A We prepare a list each day which lists 10 of our top names in inventory, and, depending upon

the decision of Mr. Van Cleave, we will make up four of those names, two of them, five of them, whatever it is his decision to do.

Q You did engage in distress selling of Penn Central Transportation Company commercial paper, did you not?

A I am sure that they were in the top 10 during this period of time, at one time or another.

Q By "this period of time" you mean 1969 or 1970?

A Yes.

Q Do the customers of the Commercial Paper Department ever inquire about bank lines of credit?

A Prior to June of 1971 extremely -- or very infrequently.

MR. MANEY: 1970?

THE WITNESS: '70. Excuse me.

Q Are bank lines of credit important in determining the salability of commercial paper?

A Prior to June 21, 1970 they were not really a major consideration, in my opinion.

Q Are they now?

A Since June 21, 1970, yes, they have be-

Deposition Testimony of George M. Van Cleave

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A I don't recall.

Q Did Goldman, Sachs have a dollar limit on inventory of commercial paper of any issuer other than Penn Central at any time in 1968, 1969 and 1970?

A Not to my knowledge.

Wait a minute, strike that. Would you repeat your question? Will you re-read the question?

(Question read)

A The answer stands.

Q In other words, Penn Central was the only commercial paper issuer as to which Goldman, Sachs & Co. established a dollar limit on the amount of commercial paper which Goldman, Sachs & Co. was willing to inventory?

A As best I can recollect.

Q Yes.

A Pardon me? As best I can recollect.

Q Do you have any doubt about that fact?

A From time to time there could be targets you might say of what you would want to keep in inventory and that is why my hesitation. I don't know that I can call them limits per se.

Q However, the amount in Penn Central was a limit, was it not?

A At that particular time, at this particular 5 million, yes. However, if my memory serves me right there was also a willingness to go above that limit at certain periods of time so I would even liken it more to a target.

Q Did Goldman, Sachs & Co. disclose to purchasers of Penn Central Commercial Paper or existing holders of Penn Central Commercial Paper that Penn Central was the only issuer as to which Goldman, Sachs & Co. had established an inventory limit?

A Not to my knowledge.

Q Did Goldman, Sachs & Co. disclose to purchasers of Penn Central Commercial Paper or existing holders of Penn Central Commercial Paper the fact that Goldman, Sachs & Co. had established a $5 million limit on inventory on or about February 5, 1970?

A Didn't I answer that?

Q No.

A Not to my knowledge.

Q Did Goldman, Sachs & Co. engage in a

Deposition Testimony of Jack A. Vogel

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Central on December 9, 1969 at Goldman, Sachs & Co.?

A If it is memorialized, I did, yes.

Q At that meeting did you point out to them that there were at that time now investors who would not buy commercial paper unless there was 100 per cent bank line coverage?

A I believe I made some comment along those lines, yes.

Q Did Penn Central have 100 per cent bank line coverage?

A To my knowledge, they did not at that time.

Q What was their bank line coverage at that time?

A To the best of my recollection, they had $50 million in standby lines and 50 million available to them under their revolving credit.

Q What was the percentage coverage which Penn Central had at that time?

A I don't know. I would have to refer back to whatever was outstanding at that time. I can't pinpoint the amount.

Q Was the coverage approximately 50 per cent during most of this time?

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"cash position"?

A Not if it is out of context with anything.

Q In making a judgment on the creditworthiness of an issuer, is it important to know the ability of a company to get bank lines of credit?

A As one part of the total picture, yes.

Q In making a judgment on the creditworthiness of an issuer, is it important to know the budget plans of the issuer?

A As a part of a whole, as part of the total picture it may be important.

Q You say it may be. Would it be?

A I just don't know. It would have to be part of a total analysis. I may conclude from a total analysis that something in addition to what I had would be needed.

Q Is it a factor you would want to know in your total analysis?

A Not necessarily.

Q In making a judgment on the creditworthiness of an issuer, is it important to know its long-term financing plans?

A As part of an overall analysis it may be and it may not be.

Deposition Testimony of John L. Weinberg

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written to me I would read.

I do get copies of some blue sheet memoranda of various companies, some of which I am responsible for and some of which are just of general interest to the Commercial Paper Department which they thought I might like to see so they would send them to me.

They send to me every day what the rates are, the rate situation. I can't recall other specific documents.

Q Do you have any personal experience in commercial paper?

A I don't quite understand the question.

Q Have you ever worked in the field of commercial paper?

A I never worked in the Commercial Paper Department.

Q Do you keep yourself informed by reading materials in the field of commercial paper?

A Well, if I see an article on commercial paper I suspect I would read it but I don't have any specified educational program. I am not trying to keep up to date.

Q Do you do any writing in the field of commercial paper?

A No, I do not.

Q Did you at any time in your years at Goldman, Sachs & Co. spend time in the Commercial Paper Department?

A I have already answered no, I have not.

Q Did the Management Committee discuss Penn Central at any meeting in 1968?

A I can't recall any. I can't recall any.

Q Did the Management Committee discuss Penn Central or Penn Central Transportation Company at any meeting in 1969?

A I can't recall any.

Q Did the Management Committee discuss Penn Central Transportation Company in any meeting in 1970?

MR. SCHWARTZ: Do you want to limit that to the period prior to June 21st?

MR. POLLACK: No.

A Well, we sure as heck discussed it when the company went into bankruptcy. But I can't recall any, you know, specific instances of discussion at the Management Committee before.

Q Before what?

A Before the Penn Central bankruptcy took place.

with the possible incorporation of the Commercial Paper Department?

MR. SCHWARTZ: I think this has been pursued to a point where it goes far beyond this inquiry. I instruct the witness not to answer.

MR. POLLACK: I press the question.

Q Was there any resolution either affirmative or negative made by the Management Committee of the recommendation by the Commercial Paper Department that that department be incorporated?

MR. SCHWARTZ: Same advice.

Q Mr. Weinberg, does Goldman, Sachs & Co. hold itself out as making a very thorough credit analysis before introducing any name to the open market?

A Yes.

Q Does Goldman, Sachs & Co. always make a very thorough credit analysis before introducing any name to the open market?

A Yes.

Q Did Goldman, Sachs & Co. make a very thorough credit analysis of Penn Central before introducing its paper to the open market?

A I believe they did, yes.

A I do not know.

Q Did you know that fact?

A I can't recall knowing it.

Q Did you instruct disclosure of that fact to potential purchasers?

A Since I did not know -- can't recall knowing the fact, I did not. I don't think I did.

Q Did you instruct disclosure of that fact to previous purchasers?

A I don't know. I can't recall.

Q Ifyou were buying commercial paper as an investor, or purchaser, would you want to know that Brown Brothers had dropped that issuer from its approved list if that issuer was a railroad issuer?

A No.

Q Are you aware of the reputation of Brown Brothers in the railroad banking field?

A Somewhat.

Q Is that reputation an outstanding reputation?

A It's a good reputation.

Q Is it correct to say that Brown Brothers, Harriman is one of the leading railroad banking

estate, the billion dollars of assets in subsidiary, the proposed bond deal, all those have to do with the so-called concept of access to credit. It is not just one thing. That is the point I have been trying to make here, that short term credit obligation requires a different kind of analysis and access to credit covers many different things, much as the concept does.

Q When you read the February 6th memorandum, which is Exhibit P-6 marked for identification, did it raise any question in your mind about the access to credit of this company as it now throw some—

MR. SCHWARTZ: There is a question pending. Give him a chance to answer it.

MR. POLLACK: All right.

A Sure it raised some questions. Sure it did.

Q In other words, it caused you to have some doubt as to the access of credit of this company?

MR. SCHWARTZ: I object to the form of that question.

MR. POLLACK: I will change the form of that question.

Q When you read this memorandum, did it create any doubt in your mind about the access to credit of Penn Central Transportation?

1220a

A It did raise some concern but again I want to reiterate, I am not in the Credit Department of Goldman, Sachs, I have not made a credit analysis and wasn't in the credit area of this with respect to Penn Central, and-- but from the very superficial facts John Weinberg knew of the situation, and I knew of the great amount of assets, the things we believed could be converted to cash, and although some concern was raised, I believed that there was access to credit, in my judgment.

But again I am not the man to talk to about this credit analysis of Penn Central. I had never made, as I testified this morning, a credit study of the company. We have competent people doing that.

Q Did you ever check up on the credit study that others allegedly made?

A I never-- I so testified that I did not.

Q So that you had no way of knowing yourself that there really was any access to credit, did you?

A Well, I had no way of knowing but from the information that I did have in a superficial way, and again I was not-- I want to reiterate again, I am not in the decision-making end of the Commercial Paper Division, that responsibility is given to Bob Wilson

in conjunction with the Credit Department.

I am in liaison with the Commercial Paper Department.

Q Did the Management Committee know that on May 25, 1970, O'Herron had told Mr. Wilson that he "can't get too worried about the commercial paper being paid as it becomes due"?

A Will you repeat that question?

(Question read.)

A I don't know if the Management Committee knew that fact.

Q Do you think that that betokens a cavalier attitude on the part of O'Herron with respect to commercial paper?

A No.

Q Did the Management Committee instruct disclosure of this fact to holders of the commercial paper?

A I do not know.

Q Was any disclosure of this fact made to holders of the paper?

A I do not know.

Q Did you know that O'Herron had said that to Wilson?

A I can't recall.

Deposition Testimony of Robert G. Wilson

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It was left at that meeting that they were to -- they were going to proceed to get ICC approval for the increase, the authorization to increase their commercial paper outstanding.

Q Have you told us all of the subjects that were raised at that meeting between you and O'Herron in September 1969?

A I believe so.

Q Who raised the subject of the necessity for lines of bank credit to support the increase in the outstanding commercial paper?

A I'm sure I did.

Q Can you tell us what you said on that subject?

A I cannot recall the exact words.

Q To the best of your recollection?

A I told John that the market at that time was becoming tighter,"tighter" to me means interest rates were continuing to rise, that investors, some investors were looking for fuller line coverage, close to 100 percent. Even for some of the very largest issuers of paper. And that this is something that he may want to give consideration to.

Q Is that the total of what you said on bank lines of credit at that meeting?

1223a

A If I have the timing right on this, I really am working from recall now, and subject to that, that by, I believe by early December we had the outstandings up to 200 from 150 to 200. That George I know talked to the railroad about the tightness that there was at the time in December in interest rates, and again this is when rates were approaching 9 per cent, short term commercial paper rates 9 per cent and that more investors were raising questions about full line coverage and I know that he talked to the railroad officials about thinking about and possibly obtaining more lines. That's one area.

The other was how the financing was proceeding, which was supposed to take place in December. And there were I think some other things but without, I can't recall them at the present time.

Q Did Van Cleave say in words or substance to the officers that they must obtain more lines?

A I think at this time in December we were encouraging the railroad to convert part of the $50 million of standby lines to what we call demand or swing lines, I think what we had in mind was for $10 million, maybe 15 of that 50 to be converted to that type of line, and I think George had a discussion with the

E. BRIEFS OF THE PARTIES

Defendant's Trial Memorandum

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light of the circumstances under which the statements were made, rendered the statements made misleading.

The statements involved here were, in essence, the implied expression of Goldman, Sachs' opinion that in its judgment Penn Central was creditworthy. There is no evidence that Goldman, Sachs did not in fact hold that opinion at the time the opinion was rendered. And no one has suggested that the expression of an opinion imposes an insurer's liability should the opinion later prove to be wrong. We concede that a professional, such as Goldman, Sachs, in expressing an opinion must have a reasonable basis for the judgment, and we submit that the sole issue in this case is whether on the date plaintiff purchased its commercial paper Goldman, Sachs in fact had a reasonable basis for concluding that Penn Central was creditworthy.

Undeniably, Goldman, Sachs, as well as nearly every major bank and credit institution in the country, was overwhelmed by the events of June 1970 -- events which were inconceivable at the time that commercial paper was sold to this plaintiff and were not contemplated either by Goldman, Sachs or by any of the other professionals whose job it was to follow the credit of Penn Central. The fact that the Railroad filed for reorganization is neither proof that Goldman, Sachs'

or implied -- which actually was made: that the issuer whose commercial paper was sold by Goldman, Sachs was, in Goldman, Sachs' opinion, creditworthy.

The courts have recognized that in certain circumstances a seller of securities who expresses an opinion about such securities must have an adequate and reasonable basis for his statement. This duty has developed under the rubric of the so-called "shingle" theory, namely, that a broker-dealer is a professional and in his business he necessarily implies that he will deal with the public as such. See Charles Hughes & Co. v. SEC, 139 F.2d 434, 436-37 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944); VI L. Loss, Securities Regulation 3720 (Supp. 1969). It is this theory that may render actionable what would otherwise be the mere expression of a point of view. See, e.g., Alexander Reid & Co., 40 S.E.C. 986, 990 (1962); 2 A. Bromberg, Securities Law: Fraud, SEC Rule 10b-5, § 8.2, at 197 (1973).

This duty does not necessarily require the disclosure of any particular fact. Rather, it looks at the entire relationship between the parties and the entire market in which the security is sold and determines whether, in light of all the circumstances, the statement made and the facts not disclosed add up to a condition of fair dealing between the parties.

In the instant case, the duty so imposed is one of investigation and analysis which arises not from the possession of particular items of information but rather from the general statement -- express or implied -- that Goldman, Sachs only sells commercial paper of issuers which it believes to be creditworthy. That duty depends upon the circumstances and cannot be generally defined for all cases. E.g., Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969) ("[T]he degree of independent investigation which must be made by a ssecurities dealer will vary in each case. Securities issued by smaller companies of recent origin obviously require more thorough investigation.") Kohler v. Kohler, 319 F.2d 634 (7th Cir. 1963); Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 289 & n.6 (E.D. La. 1974); Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 382-83 (1963).

Thus, if it be concluded that at the time of sale of Penn Central commercial paper to plaintiff Goldman, Sachs reasonably believed the company was creditworthy, the duty imposed by the "shingle" theory is satisfied. And in the absence of some other circumstance imposing an affirmative duty of disclosure, the facts that the parties did not discuss, for example, the working capital situation at Penn Central as of June 1969 should not be a basis for liability. If the

Plaintiff's Post-Trial Brief

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

UNIVERSITY HILL FOUNDATION,

Plaintiff,

- against -

71 CIV. 1166 (MEL)

GOLDMAN, SACHS & CO.,

Defendant.

PLAINTIFF'S POST-TRIAL BRIEF

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INTRODUCTION

The trial of this action commenced on October 28, 1975, and concluded on November 4, 1975. Plaintiff, UNIVERSITY HILL FOUNDATION (the "FOUNDATION"), presented two (2) live witnesses, MESSRS. NOEL LeMAY and HOWARD FITZPATRICK, and introduced approximately 75 Exhibits into evidence. Defendant, GOLDMAN, SACHS & CO. ("GOLDMAN, SACHS"), offered the live testimony of MESSRS. VAN CLEAVE, VOGEL, DOTY, LEVY and WILSON, and introduced approximately 45 Exhibits (or portions thereof) into evidence. Pursuant to a Stipulation between the parties dated October 24, 1975, the FOUNDATION has submitted designated portions of the Deposition Testimony of the following individuals:

ROBERT ANCZARKI
DAVID C. BEVAN
PAUL K. BRENKERT
G. CLIFFORD COLEMAN
GEORGE DOTY
DONALD S. DUERSON
CHARLES H. DUFFY
MICHAEL L. EVANS
WALTER P. FEKULA
CARL A. FREDERICKSEN
ROBERT HANSELL
ROBERT L. HARRE
ROBERT L. HOFFMAN
RAYMOND LEPLEY
GUSTAVE L. LEVY
ROGER M. LYNCH
JONATHAN O'HERRON
WILLIAM C. STUTT
MATTHEW TOLAN
J. JERROLD TRIPI
GEORGE M. VAN CLEAVE
JACK VOGEL
JOHN L. WEINBERG
JOHN C. WHITEHEAD
ROBERT G. WILSON.

GOLDMAN, SACHS submitted portions of the Deposition Testimony of MESSRS. LEPLEY, BEVAN and CORRIGAN. Each party submitted

counter designations to the affirmative designations of the other. In addition, as provided in the Stipulation, the parties jointly offered the trial testimony of MESSRS. SULLIVAN and ASAY in the case of Franklin Savings Bank In The City Of New York v. Gustave L. Levy, et al, (71 CIV. 882), GOLDMAN, SACHS proffering the direct and redirect testimony of SULLIVAN and the cross and recross testimony of ASAY with the FOUNDATION proffering the cross and recross testimony of SULLIVAN and the direct and redirect testimony of ASAY.

Pursuant to the direction of the Court, the FOUNDATION respectfully submits this Post Trial Brief in conjunction with its Trial Brief, in support of its contentions. Annexed hereto as Appendix "A" are brief summaries of the portions of the Deposition Testimony of those individuals who did not testify at trial which is being offered by the FOUNDATION.

This Brief shall first set forth a summary of the FOUNDATION'S argument followed by a general summary of the relevant facts which transpired during the period from February, 1969 through the filing of the petition in bankruptcy by PENN CENTRAL in June, 1970. The applicable law with respect to liability under §10b of the Securities Exchange Act of 1934 (the "'34 Act") and Rule

10b-5 promulgated thereunder, §12(a) of the Securities Act of 1933 (The "'33 Act"), the state securities laws and under the common law will then be analyzed followed by a discussion of the specific facts with respect to each misrepresentation and omission, and the general conduct, of GOLDMAN, SACHS in connection with the various legal claims. Thereafter, miscellaneous points of law such as the effect of the decision of Judge Metzner in Franklin Savings Bank In The City Of New York v. Gustave L. Levy, et al,* on the instant case, the effect of the agency relationship between the FOUNDATION and the UNION BANK on the purchase and whether the instant commercial paper is a "security" under the '34 Act will be considered.

*The opinion of Judge Metzner in Franklin Savings Bank In The City Of New York v. Gustave L. Levy, et al ("Franklin v. Levy") has been annexed hereto as Appendix "B". References to the opinion shall refer to its original page numbers. In addition, the following references shall be used herein:

PX	-	Plaintiff's Exhibit
DX	-	Defendant's Exhibit
Tr.	-	Trial Transcript
Dep.	-	Deposition Transcript
FSB Tr.	-	Trial Transcript in Franklin v. Levy
PTB	-	Plaintiff's Trial Brief
DTB	-	Defendant's Trial Brief
GSFF	-	GOLDMAN, SACHS' FINDINGS OF FACT

SUMMARY OF ARGUMENT

As is demonstrated below, the evidence establishes that GOLDMAN, SACHS, in violation of the federal and state securities acts and the common law, made a statement to the FOUNDATION which omitted a material fact necessary to make that statement, not misleading, to wit, - GOLDMAN, SACHS represented that the PENN CENTRAL commercial paper it sold was rated prime by the NATIONAL CREDIT OFFICE ("NCO"). That statement was made without revealing to the FOUNDATION that NCO'S prime rating was not the result of its independent judgment but was instead based upon GOLDMAN, SACHS' decision to continue to sell the commercial paper of PENN CENTRAL after it learned of PENN CENTRAL'S 1969 losses on February 4, 1970. In view of the testimony of NOEL LeMAY, the UNION BANK Vice-President who made the purchase on behalf of the FOUNDATION, that he would not have shown the PENN CENTRAL commercial paper to the FOUNDATION had he been aware of the foregoing [Tr. 39-40], it is submitted that this proof is dispositive of GOLDMAN, SACHS' liability and this Court need not consider the balance of the FOUNDATION'S contentions in awarding the FOUNDATION damages.

In the event the Court finds otherwise, it is sub-

mitted that the following omissions independently and certainly in the aggregate constitute material omissions by GOLDMAN, SACHS in connection with its sale of commercial paper to the FOUNDATION:

1. GOLDMAN, SACHS did not disclose its futile efforts to have PENN CENTRAL increase the bankline coverage for its commercial paper from 50% to 100%;

2. GOLDMAN, SACHS did not disclose its $10,000,000 reduction in inventory of PENN CENTRAL commercial paper and its subsequent $5,000,000 inventory limit;

3. GOLDMAN, SACHS did not disclose the removal by BROWN BROS. HARRIMAN & CO. ("BROWN BROS.") of PENN CENTRAL commercial paper from its list of approved issuers;

4. GOLDMAN, SACHS did not disclose PENN CENTRAL'S tight cash position, its lack of working capital and its increasing losses; and

5. GOLDMAN, SACHS did not disclose that PENN CENTRAL was using the proceeds from its sales of commercial paper for non-current transactions and the ICC'S concern over this practice.

Particular attention should be given to omissions "2" and "3", which omissions were held material in Franklin v. Levy, and thus should be dispositive of the instant case under the doctrine of collateral estoppel.*

Equally important is the "banklines" omission.

*See Point III, infra.

The uncontroverted evidence demonstrates that GOLDMAN, SACHS since at least February, 1969 through March, 1970, attempted in vain to have PENN CENTRAL raise the bankline coverage for its commercial paper from 50% to 100% at a time when GOLDMAN, SACHS' "sophisticated" and "professional" commercial paper investors "more and more" (Tr. 514) wanted commercial paper with 100% bankline coverage and some investors would not buy commercial paper without it. During this same period, GOLDMAN, SACHS' commercial paper issuers customarily had 100% bankline coverage, GOLDMAN, SACHS encouraged full line coverage [Tr. 783] and PENN CENTRAL was worried that its paper with only 50% bankline coverage would be "sticking out like a sore thumb..." [LEPLEY Dep. 49, 50]. Since GOLDMAN, SACHS admits its commercial paper investors were sophisticated and professional and since the uncontroverted evidence establishes that many of these investors wanted 100% bankline coverage, one must inevitably conclude that GOLDMAN, SACHS' failure to advise the FOUNDATION of the facts surrounding its unsuccessful efforts to have PENN CENTRAL raise its bankline coverage was a material omission under the Supreme Court's materiality test as set forth in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972):

> "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important

in the making of this decision." (Emphasis Supplied)

Can GOLDMAN, SACHS be heard to argue that its investors, albeit sophisticated and professional, were at the same time unreasonable in seeking only that commercial paper which had 100% bankline coverage?*

Although GOLDMAN, SACHS admits that in selling PENN CENTRAL commercial paper it made the material representation that PENN CENTRAL was creditworthy, it vehemently denies that this representation was not true, despite that according to VOGEL'S own criterion ("If it is not creditworthy, they won't get banklines..." [Tr. 593-594]), the inability of PENN CENTRAL to obtain additional banklines leads to the conclusion that PENN CENTRAL was not creditworthy. The details of GOLDMAN, SACHS' inadequate credit analysis and the myth of its continuing credit analysis is discussed at length in Point II A, infra. It is sufficient to say at this point that VOGEL and WILSON (GOLDMAN, SACHS' credit experts) both testified at trial that in concluding that PENN CENTRAL was creditworthy they placed heavy reliance on PENN CENTRAL'S $6,000,000,000 of assets [Tr. 493, 565]. This reliance existed even though WILSON did not know if the transportation company's commercial paper holders had access to the assets of the parent company [Tr. 997] and despite uncontroverted evidence revealing that PENN CENTRAL in a public document (which

*Undaunted by this logical inconsistency GOLDMAN, SACHS' witnesses characterized the desire of its sophisticated and professional commercial paper investors for 100% bankline coverage as "arbitrary" and laziness on the part of its investors who were merely seeking a "credit short cut" or "crutch" [Tr. 511, 514, 867, 949].

refers to GOLDMAN, SACHS) signed by O'HERRON and filed with the Interstate Commerce Commission ("ICC") advised the ICC that PENN CENTRAL had "assets of approximately $4.5 billion" [PX-67], and O'HERRON of PENN CENTRAL advised VOGEL of GOLDMAN, SACHS on September 11, 1969 that PENN CENTRAL had "a total asset structure of some $4-1/2 billion ..." [PX-20]. It belabors the obvious to argue that a credit analysis based on $1,500,000,000 in non-existent assets was inadequately conducted and that its results are not accurate.

According to the standards set forth in Sanders v. John Nuveen & Co., Inc. [1975] CCH Fed. Sec. L. Rep. ¶95,347 at 98,724 (7th Cir. 1975),

> "...a greater quantity of information is 'reasonably ascertainable' by an underwriter than by a mere broker, and something more than published data must be analysed if an underwriter is to discharge his duty of investigation" (Emphasis Supplied)

As a matter of law, GOLDMAN, SACHS has violated its duty as an underwriter of the PENN CENTRAL commercial paper by not having conducted such an investigation. This deficiency is cogently illustrated by the following testimony of WILSON:

> "I didn't see any need for it. I had just finished having a luncheon with the Chairman of the Finance Committee and the treasurer of the railroad and they told me what their forecasts or estimates for 1970 were going to be. So I saw no need to ask for the underlying documents and all the assumptions that would go into these figures with all the various subsidiaries and the assumptions on earnings and so on that would go into this final product. No, I did not ask for it. I had the end result from the Chairman of the Finance Committee." [Tr. 897, 898]

GOLDMAN, SACHS' legal posture has been to argue that it merely represented to the FOUNDATION that PENN CENTRAL was creditworthy (ignoring, of course, the uncontroverted testimony that GOLDMAN, SACHS represented the paper to be NCO Prime) and that this representation was true when made to the FOUNDATION on March 13, 1970. It further contends that the omissions were not material and that because of the nature of the commercial market, in particular the "compressed" selling day of GOLDMAN, SACHS, there was no duty to disclose the omitted facts. If the latter argument were adopted, the Court would, in effect, be holding that under ordinary circumstances the disclosure and investigation requirements of the securities laws do not apply to commercial paper dealers, a holding which contravenes the recent decision of Sanders v. John Nuveen & Co., Inc., supra.

GOLDMAN, SACHS' finely constructed legal arguments, supported by its travelling parade of case hardened witnesses, must nevertheless fail because they rest on the shifting sands of hindsignt, rationalization, half-truths, omissions and sophistry. Some examples:

1. WILSON, LEVY, VOGEL and WEINBERG were "surprised", "disturbed" and "worried" about the railroad's 1969 losses as announced on February 4, 1970 [Tr. 773-778, 793, 987, 988, 989]. Accordingly, GOLDMAN, SACHS arranged for a meeting with BEVAN and O'HERRON on February

6, 1970. GOLDMAN, SACHS' witnesses testified that they were satisfied with BEVAN'S explanations at the meetings (e.g., "...BEVAN did a through [sic] job of explaining 1969's $56MM operating loss in the railroad" [PX-12]) and therefore had no more cause for concern (since "it was a very positive meeting" [Tr. 544, 981-982]). GOLDMAN, SACHS' witnesses did not, however, testify that the February 6, 1970 meeting with BEVAN was merely a whitewash for cosmetic purposes since GOLDMAN, SACHS had, prior to the February 6, 1970 meeting, determined that it would continue to sell PENN CENTRAL'S commercial paper. Thus, on February 5, 1970, VOGEL advised ROGERS of NCO "that Goldman, Sachs was continuing to sell the commercial paper notes of Penn Central Transportation Company" [PX-10] and WILSON advised O'HERRON that GOLDMAN, SACHS "was going to continue to offer their paper, not only the $15,510,000 in inventory, but also the maturities as they come due." [PX-11].

2. At trial GOLDMAN, SACHS permitted its witnesses to testify to their opinions as to how PENN CENTRAL could have raised cash and why PENN CENTRAL did not have to go into bankruptcy on June 21, 1970 [Tr. 933-937] while it objected (successfully) to the introduction in evidence of PX-115 for identification [Tr. 217-219], PENN CENTRAL'S bankruptcy petition signed by DAVID A. GORMAN, Chairman of PENN CENTRAL. This public document reveals that:

"The Debtor has been suffering large deficits since 1968 and is virtually without cash.

4. The Debtor is unable to meet its debts as they mature, has no means of borrowing or otherwise procuring funds to pay and discharge its debts and obligations, and desires to effect a plan of reorganization pursuant to Section 77 of the Bankruptcy Act." [Emphasis Supplied]

3. GOLDMAN, SACHS' argument that its decision on February 6, 1970 to limit its inventory of PENN CENTRAL commercial paper to $5,000,000 and to have PENN CENTRAL repurchase $10,000,000 of its paper from inventory was based solely on pre-existing policies and had no relaionship to PENN CENTRAL'S creditworthiness [Tr. 822, 823].

4. GOLDMAN, SACHS' argument that the fact that it never carried any PENN CENTRAL commercial paper in inventory after April 8, 1970 [DX-CU] (although it continued to sell the paper on a special order, tap issue "no risk" basis) was not the result of any conscious determination nor was it related to its actions of February 6, 1970 [Tr. 814-816].

5. The constant references of GOLDMAN, SACHS' witnesses to negative carry "losses" and mark-up losses in 1968 and 1969 even though these are clearly expense items above which the commercial paper department of GOLD-

MAN, SACHS made net profits which increased from $267,000 in 1968 to $435,000 in 1969 [Tr. 294, 447].

6. GOLDMAN, SACHS' attempts to justify its pre-June, 1970 behavior by resort to information which existed prior to June, 1970 but was not used, much less put in useable form until after June, 1970. Thus, WILSON testified that at counsel's request in connection with this litigation he for the first time calculated the gross receipts received by GOLDMAN, SACHS from the sale of PENN CENTRAL commercial paper in 1968, 1969 and 1970 [Tr. 924-927].

7. The testimony of JACK VOGEL, the long time head of the Credit Department, that he personally did the initial credit investigation of PENN CENTRAL but did not take the time to reduce his report to writing [Tr. 492, 641]. Furthermore, although he frequently made written calculations to determine the unencumbered value of PENN CENTRAL'S liquid assets, he did not bother to save or send these calculations to the credit file (thus necessitating new calculations starting from scratch on each of the frequent occasions on which he updated his calculations) [Tr. 504-507, 641]. Accordingly, there is not one writing in the voluminous PENN CENTRAL credit file [DX-A] which re-

flects the extended credit analysis of PENN CENTRAL by VOGEL.

Accordingly, GOLDMAN, SACHS made material misrepresentations and omissions in connection with the sale of PENN CENTRAL commercial paper to the FOUNDATION. In addition, it will be shown that GOLDMAN, SACHS was engaged in a general scheme or course of fraudulent conduct to perpetuate PENN CENTRAL and the commercial paper market. Therefore, GOLDMAN, SACHS clearly violated the federal and state securities laws, and the common law. It is consequently liable to the FOUNDATION in damages, plus appropriate interest and costs.

SUMMARY OF FACTS

The significant facts relating to each misrepresentation and omission and the fraudulent conduct of GOLDMAN, SACHS are set forth in detail hereinafter. At this point, a summary of the facts is provided in order to appreciate the setting and circumstances under which the misrepresentations, omissions and fraudulent conduct of GOLDMAN, SACHS occurred.

GOLDMAN, SACHS is a partnership engaged in the business of investment banking, underwriting and dealing in the purchase and sale of securities including commercial paper. Its principal office is in New York, New York, with offices in Los Angeles, California and other cities. It is a registered broker-dealer under the '34 Act, and a member of the New York Stock Exchange, other national securities exchanges and the National Association Of Securities Dealers, Inc. Since its organization in 1869, GOLDMAN, SACHS has been a dealer in commercial paper and, over the years, has become the largest and most important commerical paper dealer. Thus, in 1969 and 1970, GOLDMAN, SACHS had approximately 45% of the commercial paper market [Tr. 237]. When acting as a dealer, GOLDMAN, SACHS would in almost every instance purchase commercial paper directly

from an issuer and resell it as principal to its customers [Tr. 225; GSFF: 24, 37]. As a result, GOLDMAN, SACHS maintained a substantial inventory of commercial paper for the issuers it handled and, as of March, 1970, had commercial paper of approximately 200 to 250 issuers in its inventory [Tr. 939]. GOLDMAN, SACHS would only sell the commercial paper of issuers which it deemed creditworthy after a credit investigation had been performed by it [Tr. 483, 484]. As a consequence, by offering the commercial paper of an issuer to an investor, GOLDMAN, SACHS represented that an adequate credit investigation had been conducted by it, that the issuer of the commercial paper was creditworthy and recommended the commercial paper for purchase [WEINBERG Dep. 41; Tr. 806, 807].

In February, 1968, the merger between the NEW YORK CENTRAL and the PENNSYLVANIA RAILROAD was consummated. The resulting corporation was the PENN CENTRAL COMPANY which changed its name to the PENN CENTRAL TRANSPORTATION COMPANY ("PENN CENTRAL")* on October 1, 1969. The PENN CENTRAL COMPANY became the publicly held parent of PENN CENTRAL and wholly owned PENN CENTRAL [GSFF: 29]. GOLDMAN, SACHS commenced issuing the commercial paper of PENN CENTRAL on or about August 1, 1968 [GSFF: 36] and, at the insistence of

*As used throughout this Brief, PENN CENTRAL refers to the TRANSPORTATION COMPANY resulting from the merger regardless of the date.

GOLDMAN, SACHS, was at all times the exclusive dealer for the PENN CENTRAL commercial paper [Tr. 427, 429]*.

Prior to issuing the commercial paper, GOLDMAN, SACHS allegedly conducted an initial credit investigation of PENN CENTRAL. The initial credit investigation was performed primarily by JACK VOGEL (head of GOLDMAN, SACHS' commercial paper department) [Tr. 556] and was essentially based upon a review of public information such as annual reports of PENN CENTRAL and exerpts from Moody's Transportation Manual [Tr. 481, 488, 493]. The initial credit investigation concluded that PENN CENTRAL was creditworthy [Tr. 483] as did the subsequent "continuing" credit investigations [HOFFMAN Dep. 36, 42; EVANS Dep. 57; PX-39]. All of the credit reports and related calculations prepared by VOGEL, if in writing, were thrown out and never put in the credit file [Tr. 406, 641].

When GOLDMAN, SACHS began selling PENN CENTRAL commercial paper, PENN CENTRAL had been authorized by the ICC to have outstandings of $100,000,000 [GSFF: 35]. At that time, PENN CENTRAL had bankline coverage of approximately 50% [Tr. 582]. Thereafter, PENN CENTRAL applied to the ICC to increase its commercial paper outstandings to $150,000,000 and in March, 1969, the ICC approved such increase [GSFF: 41].

*In addition to being the exclusive commercial paper dealer for PENN CENTRAL, GOLDMAN, SACHS did or contemplated doing other business with PENN CENTRAL during the period 1968 through 1970, e.g. contingent compensation fund [PX-19], securities investment [PX-25, DX-A72, A73, A74], establishment of a captive finance company [PX-25] and lease financing [PX-22].

The application to the ICC included a written opinion from GOLDMAN, SACHS that if market conditions remained the same, GOLDMAN, SACHS could keep $150,000,000 of the commercial paper outstanding [GSFF: 42].

On September 19, 1969, a meeting was held between GOLDMAN, SACHS and PENN CENTRAL attended by VOGEL, ROBERT G. WILSON (partner in charge of GOLDMAN, SACHS' commercial paper department), LOUIS E. DRYPOLCHER (commercial paper buyer for GOLDMAN, SACHS) and JOHN O'HERRON (Vice-President-Finance of PENN CENTRAL) [PX-20]. At that meeting, inter alia, O'HERRON told GOLDMAN, SACHS that PENN CENTRAL had applied to the ICC to increase its outstanding commercial paper from $150,000,000 to $200,000,000 and that PENN CENTRAL would be in a very tight cash position in the first quarter of 1970. WILSON told O'HERRON that investors were becoming more concerned with bankline coverage of commercial paper and asked if PENN CENTRAL could obtain $50,000,000 more in bankline coverage. O'HERRON indicated that he preferred not to increase the coverage and WILSON said he would not insist on the increase at that time [PX-20]. On October 22, 1969, O'HERRON telephoned WILSON and said PENN CENTRAL would show a "small loss in the third quarter but anticipate[d] the 4th quarter ... [would] be 'in the black' with a good improvement" [PX-33]. On November 10, 1969, WILSON again told O'HERRON to consider

obtaining $50,000,000 more in bankline coverage [PX-28].

On October 29, 1969, the ICC approved PENN CENTRAL'S application to increase its outstanding commercial paper to $200,000,000 [PX-64]. In connection with this application, GOLDMAN, SACHS gave its oral opinion to PENN CENTRAL that outstandings in this increased amount would be maintained if market conditions did not change [Tr. 973]. The bankline coverage with respect to the $200,000,000 of PENN CENTRAL commercial paper was $100,000,000 or 50% consisting of $50,000,000 from a revolving credit agreement and $50,000,000 from outside credit lines [PX-20]. At no time did PENN CENTRAL have bankline coverage in excess of $100,000,000 [Tr. 385].

On December 9, 1969, another meeting* was held between GOLDMAN, SACHS and PENN CENTRAL [PX-22]. During the course of the meeting, VOGEL told PENN CENTRAL that although GOLDMAN, SACHS did not feel 100% coverage was necessary, some investors would not buy commercial paper unless it had 100% bankline coverage. GOLDMAN, SACHS was concerned about its $16,000,000 inventory position, the largest it ever had, in view of the tight market and adverse publicity regarding PENN CENTRAL. On or about December 23, 1969, PENN CENTRAL repurchased $16,170,000 of its

*No attempt has been made to set forth all the meetings and/or conversations which occurred between GOLDMAN, SACHS and PENN CENTRAL.

commercial paper from GOLDMAN, SACHS inventory. The money utilized by PENN CENTRAL for the repurchase came from the proceeds from the sale of a $50,000,000 debenture of the PENNSYLVANIA COMPANY [Tr. 437]. No inventory limitation was connected with this repurchase and at the time of the repurchase PENN CENTRAL commercial paper was selling well. [Tr. 438]. As a result of the repurchase, GOLDMAN, SACHS held only $50,000 of PENN CENTRAL commercial paper in its inventory [Tr. 309]. By February 5, 1970, GOLDMAN, SACHS' inventory of PENN CENTRAL commercial paper had increased to $15,510,000 [PX-11].

On February 4, 1970, PENN CENTRAL publicly announced a $56,000,000 loss for the year 1969 (which included a loss of $16,000,000 for the fourth quarter of 1969) [PX-11, Tr. 871]. Upon learning of these losses, WILSON called GUSTAVE L. LEVY (GOLDMAN, SACHS' managing partner and primary contact with PENN CENTRAL) in St. Louis, Missouri [Tr. 872, PX-11].

On the morning of February 5, 1970, after calling JAMES HEMPHILL (a senior partner of GOLDMAN, SACHS who "had devoted his whole career to commercial paper" [Tr. 873]), WILSON called O'HERRON and told him that he thought the news of the losses would have an adverse effect on commercial paper sales and that the most important thing PENN CENTRAL could do

was to obtain $100,000,000 more in bankline coverage, thereby bringing the coverage to 100% [PX-11]. O'HERRON told WILSON that PENN CENTRAL'S cash position for the first six months of 1970 would be very tight and that PENN CENTRAL would require about $200,000,000 to meet its cash needs. WILSON asked PENN CENTRAL to buy back $10,000,000 of GOLDMAN, SACHS' $15,000,000 PENN CENTRAL commercial paper inventory and O'HERRON agreed to make the repurchase on February 9, 1970 [PX-11].

It was also on February 5, 1970 that ALAN ROGERS of NATIONAL CREDIT OFFICE ("NCO") telephoned VOGEL about his concern over the "sharply reduced earnings" of PENN CENTRAL. ROGERS asked if GOLDMAN, SACHS was continuing to sell PENN CENTRAL'S commercial paper. VOGEL replied affirmatively and ROGERS said that as a result NCO would continue to rate PENN CENTRAL as a prime name [PX-10].

On February 6, 1970, a luncheon meeting was held between GOLDMAN, SACHS and PENN CENTRAL. LEVY, WILSON, DAVID C. BEVAN (Executive Vice-President, Chief Financial Officer and Chairman of the Finance Committee of the Board of Directors of PENN CENTRAL) and LODER were present. GOLDMAN, SACHS told PENN CENTRAL that if $100,000,000 in banklines was not obtained to bring the coverage for the commercial paper to 100%, a $50,000,000 to $100,000,000 run off on the outstand-

ing $200,000,000 in commercial paper would occur. Both O'HERRON and BEVAN stated they did not think PENN CENTRAL could obtain $100,000,000 in additional bankline coverage. PENN CENTRAL was further informed that after the $10,000,000 buy-back, GOLDMAN, SACHS would limit its PENN CENTRAL commercial paper inventory to $5,000,000 and that PENN CENTRAL was to have backup lines "available" to "cover" GOLDMAN, SACHS' "$5MM position". Finally, GOLDMAN, SACHS told PENN CENTRAL that a "large New York firm [i.e. BROWN BROS.] that has bought as much as 15% of their [PENN CENTRAL'S] outstandings [of commercial paper]" had removed PENN CENTRAL temporarily from its approved list of issuers. Obviously concerned, O'HERRON asked WILSON to find out why BROWN BROS. had done this [Tr. 956]. In addition, the VOGEL-ROGERS conversation was related to PENN CENTRAL. [PX-12].

Pursuant to the telephone conversation between WILSON and O'HERRON on February 5, 1970 (a Thursday), on February 9, 1970 (a Monday), PENN CENTRAL repurchased $10,000,000 of GOLDMAN, SACHS' PENN CENTRAL commercial paper inventory. The funds utilized by PENN CENTRAL for the repurchase were obtained by resort to PENN CENTRAL'S existing banklines of credit [PX-12]. In accordance with the inventory limitation imposed by GOLDMAN, SACHS the PENN CENTRAL commercial paper inventory of GOLDMAN, SACHS did not thereafter exceed $5,000,000 save a few temporary exceptions

[Tr. 315]. Indeed, after April 8, 1970, GOLDMAN, SACHS carried no PENN CENTRAL commercial paper in its inventory [DX-CU] although it continued to sell the commercial paper on a no risk "tap issue" basis until investors stopped buying it in May, 1970 [Tr. 814, DX-CU].

On April 22, 1970, WILSON learned of PENN CENTRAL'S "staggering" [Tr. 1001] losses of $62,709,000 for the first three mont' s of 1970 by reading PENN CENTRAL'S press release [PX-46; Tr. 1003-1005]. WILSON then "directed" his commercial paper salesmen to disclose first quarter results to investors [Tr. 911, 912, PX-18] because he wanted to avoid the problem of having an "account" that "had not seen this news" and bought the paper asking to "sell it back to GOLDMAN, SACHS" [Tr. 913]. As noted, GOLDMAN, SACHS was no longer inventorying PENN CENTRAL commercial paper at this time. Moreover, such an instruction was not given in connection with PENN CENTRAL'S announcement on February 4, 1970 of its losses for 1969 [WILSON Dep. 481-483; ANCZARKI Dep. 59], when GOLDMAN, SACHS was inventorying PENN CENTRAL commercial paper and was an unusual procedure [TOLAN Dep. 32].

On June 21, 1970, PENN CENTRAL filed its voluntary Petition For Reorganization pursuant to Chapter 77 of the Bankruptcy Act [Tr. 217]. On that date, although its customers held approximately $80,000,000 of PENN CENTRAL commercial paper, GOLDMAN, SACHS had no PENN CENTRAL commercial

paper in its inventory [DX-CU].

The FOUNDATION is a California non-profit charitable corporation [Tr. 101]. Its primary purpose is to raise and channel funds to Loyola University [Tr. 99, PX-8]. The FOUNDATION is essentially operated by its part-time* President, HOWARD FITZPATRICK, who has served in that capacity from early 1969 to date [Tr. 103]. Although FITZPATRICK makes the investment decisions of the FOUNDATION [Tr. 104], he is not an expert or sophisticated investor [Tr. 99-101]. When the FOUNDATION has available funds, FITZPATRICK invests the same in short term money market instruments such as certificates of deposit or commercial paper [Tr. 105, 106]. Some of these investments were made through or by the UNION BANK of Los Angeles, California [Tr. 105] of which the FOUNDATION was a customer and depositor [Tr. 104]. With respect to the purchases of commercial paper, FITZPATRICK would deal with NOEL G. LeMAY, a Vice-President of the UNION BANK [Tr. 105]. The UNION BANK charged no fee to the FOUNDATION for purchasing commercial paper in its behalf [Tr. 5, 105].

In purchasing commercial paper, FITZPATRICK'S "No. 1" criterion "was safety, quality" [Tr. 107, 108]. Thus, in buying commercial paper, the FOUNDATION always required "prime" paper which "meant" to FITZPATRICK "the ultimate in safety" [Tr. 109]. Prior to March 1, 1970, FITZPATRICK had advised

*FITZPATRICK is a full-time paint contractor [Tr. 100, 101]. The FOUNDATION'S only other employee [part-time] is Mr. FITZPATRICK'S secretary [Tr. 104].

LeMAY that in connection with commercial paper, the FOUNDATION only wanted prime commercial paper [Tr. 11, 109] or "the best quality" [Tr. 110]. Accordingly, LeMAY only showed prime commercial paper to FITZPATRICK and never purchased or was instructed to purchase commercial paper for the FOUNDATION which was other than prime [Tr. 12]. Moreover, at this time the UNION BANK had a "requirement" that it only show its customers "prime" commercial paper [Tr. 5]. Prior to March 13, 1970, GOLDMAN, SACHS' Los Angeles office was aware that the UNION BANK only wanted prime commercial paper [Tr. 7, 8].

In the beginning of March, 1970, the FOUNDATION had investments of approximately $600,000 which were maturing at the UNION BANK [Tr. 111]. On the morning of March 13, 1970, FITZPATRICK telephoned LeMAY and asked him, as he had on prior occasions, to ascertain what prime commercial paper was available as a short term investment for the FOUNDATION'S $600,000 [Tr. 13, 14, 112]. LeMAY then telephoned the Los Angeles office of GOLDMAN, SACHS, requested prime commercial paper and was given the name of PENN CENTRAL and two or three other companies [Tr. 13-16]. On that same day, LeMAY and FITZPATRICK had a second telephone conversation in the course of which LeMAY informed FITZPATRICK of the 3 or 4 different prime commercial papers which GOLDMAN, SACHS had advised him were available [Tr. 16, 17, 112, 115]. FITZPATRICK then elected to purchase the PENN CENTRAL

commercial paper because:

> "Principally is the image quality of the size of PENN CENTRAL and that meant safety to me, the rate was favorable, and their maturity situation fitted our requirements." [Tr. 115]

On that same day (a Friday) LeMAY placed the FOUNDATION'S order for PENN CENTRAL commercial paper having a face value of $600,000 with GOLDMAN, SACHS' Los Angeles office [Tr. 17, 21]. The actual purchase took place in New York City on March 16, 1970 (a Monday) through correspondent banks [Tr. 25, PX-3, 4, 5, 6, 7].

The FOUNDATION is presently in possession of two PENN CENTRAL notes dated December 30, 1969 payable to the order of bearer on September 25, 1970, having an aggregate face value of $600,000 [PX-1, 2]. On September 25, 1970, the maturity date of the notes, the Irving Trust Company presented them for payment and payment was refused [Tr. 22]. To date, the FOUNDATION has not received any payment in connection with the notes.

POINT I

THE FOUNDATION HAS SATISFIED THE LEGAL REQUIREMENTS FOR THE IMPOSITION OF LIABILITY UNDER THE FEDERAL AND STATE SECURITIES LAWS AND UNDER THE COMMON LAW

In this point, the controlling principles of law in connection with the imposition of liability with respect to misrepresentations, omissions and fraudulent conduct under the federal and state securities laws and under the common law will be analyzed. Thereafter, the detailed facts relating to each misrepresentation and omission and the fraudulent conduct of GOLDMAN, SACHS upon which liability is predicated will be discussed in relation to the applicable law.

However, before considering the relevant legal principles, it is instructive to review briefly the basic arguments* advocated by GOLDMAN, SACHS in its Trial Brief.

Notwithstanding the legion of cases which confirm that the legislative purpose of the securities laws is full disclosure of all material facts in connection

*Under §12(2) of the '33 Act and Rule 10b-5 of the '34 Act. The remaining arguments of GOLDMAN, SACHS will be considered in the context of the FOUNDATION'S arguments.

with the sale of a security, GOLDMAN, SACHS maintains that with respect to the commercial paper market an exception should, indeed does, exist whereby material facts need not be revealed to prospective purchasers. The exception is predicated on the fact that in the commercial paper market sales are transacted in a brief period of time and investors are sophisticated. Accordingly, investors do not expect disclosure of material facts and are content to rely solely upon the judgment of a dealer/underwriter with respect to the creditworthiness of an issuer. GOLDMAN, SACHS therefore contends that the only issue presented in the instant case is whether or not its judgment that PENN CENTRAL was creditworthy had a reasonable basis and, if a reasonable basis existed, there can be no liability for a misrepresentation.

With respect to omissions under §12(2) of the '33 Act, while conceding that no scienter requirement exists, GOLDMAN, SACHS maintains that only an omission of a material fact which is necessary to make other statements not made misleading (as opposed to bare or complete omissions) under the circumstances is actionable. Liability can not be founded upon any omission because any fact which may have been omitted was not required to make the only statement made, that PENN CENTRAL was creditworthy, not misleading. Furthermore, in the context of the unique com-

mercial paper market (or "in light of the circumstances" in which the creditworthy statement was made) where only judgments were expected or important, no fact could be material or its omission actionable. By the same reasoning, since no fact could be material or important, there could be no causal relation between the purchase by the FOUNDATION and any omission, or, otherwise stated, the FOUNDATION did not rely on any omission. In any event, GOLDMAN, SACHS argues that the FOUNDATION knew or should have known any material facts omitted and that ignorance with respect to such facts was inexcusable, thereby precluding liability.

GOLDMAN, SACHS similarly maintains that liability under §10b and Rule 10b-5 of the '34 Act can not be established. In refuting liability, a distinction is made between Rule 10b-5(2), the counterpart in the '34 Act to §12(2) of the '33 Act, and Rule 10b-5(1) and (3). With respect to liability under Rule 10b-5 for a misrepresentation, it is argued that no material misrepresentation was made because GOLDMAN, SACHS had a reasonable basis for believing PENN CENTRAL was creditworthy. While conceding that Rule 10b-5 generally proscribes bare or complete omissions (as opposed to omissions which render a statement made not misleading), GOLDMAN, SACHS contends that liability for such omissions may only be predicated upon Rule 10b-5(1) or (3)which relate to general fraudulent conduct, not rule 10b-5(2). Liability for an omission under

Rule 10b-5(2), therefore, will only exist if the omission would be actionable under §12(2). Because no omission is actionable under §12(2), for the reasons set forth above, liability can not be predicated on Rule 10b-5(2). It is consequently concluded that the FOUNDATION'S claim can only be founded upon Rule 10b-5 (1) or (3). However, to prevail with respect to a bare omission under Rule 10b-5(1) or (3), GOLDMAN, SACHS argues that scienter must be established. The requisite scienter is defined as a duty to disclose. Reckoning back to the premise of the "unique commercial paper market" where there is no expectation by investors of either factual disclosures or equal access to information, GOLDMAN, SACHS contends that "under the circumstances" its only duty was to have a reasonable basis for its judgment that PENN CENTRAL was creditworthy - it had no duty to disclose. Accordingly, because GOLDMAN, SACHS satisfied its "duty", there was no breach of duty and therefore no scienter or liability under Rule 10b-5(1) or (3). Finally, as under §12(2), it is argued that the FOUNDATION can not recover because it had actual or constructive (reasonable investigation) knowledge of any omission.

As will be shown, the position of GOLDMAN, SACHS is not only contrary to well established case law, but, moreover, undermines and perverts the spirit and intent

of the securities laws whose purpose is to expand, not limit or eliminate, factual disclosures to investors. It is therefore submitted that the exception advocated by GOLDMAN, SACHS, as well as the attenuated legal arguments predicated on such exception, should not be adopted.

A. LIABILITY UNDER RULE 10b-5

Rule 10b-5, promulgated pursuant to §10b of the '34 Act, provides:

> "It shall be unlawful for any person, directly or by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

Based on the language of the Rule, three general types of conduct are proscribed:

(1) Misrepresentations - making an untrue statement of material fact [10b-5(2)];

(2) Omissions - omitting to state a material fact necessary to make statements made not misleading, i.e "half truths" [10b-5(2)] and bare or complete omissions as opposed to "half truths" [10b-5(1) and (3)]; and

(3) Practices which are fraudulent [10b-5(1) and (3)].

Although Courts generally do not dissect Rule 10b-5 into its component subsections, nonetheless, because the arguments of GOLDMAN, SACHS rely on distinctions within the Rule, an analysis of the legal requirements with respect to the three types of prohibited conduct is necessitated.

(1) MISREPRESENTATIONS - MAKING AN UNTRUE STATEMENT OF MATERIAL FACT [10b-5(2)]

In connection with the sale of the PENN CENTRAL commercial paper to the FOUNDATION, GOLDMAN, SACHS made two statements: (1) that PENN CENTRAL was creditworthy, and (2) that GOLDMAN, SACHS conducted an adequate credit investigation of PENN CENTRAL. The discussion of the facts regarding these two statements, infra, clearly establishes that both were false or untrue. To be action-

able, however, a false or untrue statement must be material, be made with the requisite scienter and satisfy the tests for reliance or causation. In addition, a plaintiff must meet certain standards with respect to lack of knowledge. Each of these elements will be discussed herein.

The test for determining whether a statement is material was set forth in SEC v. Texas Gulf Sulphur, 401 F. 2d 833, 849 (2d Cir. 1968):

> "As we stated in List v. Fashion Park, Inc., 340 F. 2d 457, 462, 'The basic test of materiality ... is whether a reasonable man would attach importance ... in determining his choice of action in the transaction in question. Restatement, Torts §538(2)(a); accord Prosser, Torts 554-55; I Harper & James, Torts 565-66.' (Emphasis Supplied). This, of course, encompasses any fact ' ... which in reasonable and objective contemplation might affect the value of the corporation's stock or securities ...'" (Citations Omitted).

See also Rochez Bros., Inc. v. Rhoades, 491 F. 2d 402 (3rd Cir. 1974). As indicated hereinafter, because the FOUNDATION considered the statements of GOLDMAN, SACHS "important" with respect to the purchase of the PENN CENTRAL commercial paper, the same were material.

Although there is substantial authority to the effect that negligence is sufficient for the imposition of liability under 10b-5(2)*, the generally accepted scienter

*See 2A. Bromberg, Securities Fraud, §8.4(505), p. 204.106 (1974).

requirement in the Second Circuit with respect to misrepresentations was articulated in Cohen v. Franchard Corporation, 478 F. 2d 115, 123-124 (2d Cir. 1973):

> "We uniformly have held that a party cannot be held liable in a private suit for damages under Rule 10b-5 for mere negligent conduct. See e.g. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 48 F. 2d 341, 363 ... SEC v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1096 n. 15 (2 Cir. 1972); Shemtob v. Shearson, Hammill & Co., 448 F. 2d 442, 445 (2 Cir. 1971). Although it is unnecessary to prove the specific fraudulent intent essential to a claim of common law fraud, it must be established that the defendant was to some extent cognizant of the misstatement or omission. Globus v. Law Research Service, Inc., 418 F. 2d 1276, 1290-91 (2 Cir. 1969) ... Heit v. Weitzen, 402 F. 2d 909, 913-14 (2 Cir. 1968) ... The standard for determining liability under Rule 10b-5 essentially is whether plaintiff has established that defendant either knew material facts that were misstated or omitted and should have realized their significance or failed or refused to ascertain and disclose such facts when they were readily available to him and he had reasonable grounds to believe that they existed. See Chris-Craft Industries, Inc. v. Piper Aircraft Corp., supra, 480 F. 2d at 363... It is not enough for plaintiff to show that defendant failed to detect certain material facts wher he had no reason to suspect their existence.... Accordingly, since the court in substance charged actual knowledge of falsity or reckless disregard for the truth - in language that conveyed the essence of the standard stated above - we hold that its charge on scienter was essentially correct.

See also Lanza v. Drexel & Co., 479 F. 2d 1277, 1306 (2d Cir. 1973), wherein the Court stated:

> "In sum, we believe that proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5." (Footnote omitted).

and set forth the test for "reckless disregard for the

truth" as:

> "whether the defendants ... failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort..." (id., fn. 98) [Citation omitted].

In connection with the above cited language, the Court referred to the ALI Federal Securities Code, §251A, Tentative Draft No. 2 (March 1973) for a definition of knowledge (id., fn. 11):

> "Sec. 251A. [knowledge]. When reference is made to this section, a misrepresentation is known by a person to be a misrepresentation if he (a) knows or believes that the matter is otherwise than represented, (b) does not have confidence in its existence or non-existence that he expresses or implies, or (c) knows that he does not have the basis that he states or implies he has for his belief." (Emphasis Supplied).

Accordingly, if GOLDMAN, SACHS either (1) knew that PENN CENTRAL was not creditworthy, (2) made such statements in disregard of or indifference to the truth or the risk that the FOUNDATION would be mislead, or (3) had no confidence in such statements, the requisite scienter will be established. As will be shown, not only did GOLDMAN, SACHS know that the two representations made in connection with the sale of commercial paper to the FOUNDATION were false, but (in the event GOLDMAN, SACHS had no knowledge) such state-

ments were made recklessly with indifference and disregard for their truth and GOLDMAN, SACHS had no confidence in the statements.

With respect to the element of reliance or causation, the factual discussions will show that the FOUNDATION relied on the two representations made by GOLDMAN, SACHS. In any event, reliance may be inferred from the totality of the circumstances or presumed from the materiality of the representation (Reeder v. Mastercraft Electronics Corporation, 363 F. Supp. 574 (S.D.N.Y. 1973); Chris-Craft Industries v. Bangor Punta Corp. [1973] CCH Fed. Sec. L. Rep. ¶93,816 at 93,491 (2d Cir. 1973)) and the factual discussions will establish that the representations of GOLDMAN, SACHS were material or at least justify the inference of reliance.

The final element that must be established in connection with a Rule 10b-5 misrepresentation is that the plaintiff had neither actual nor constructive knowledge of the misrepresentation or, otherwise stated, that the plaintiff was reasonable in relying on the false statement. Lanza v. Drexel [1970[CCH Fed. Sec. L. Rep. ¶92,826 at 90,089 (S.D.N.Y. 1970) (by implication). The factual discussions relating to the two misrepresentations will establish that the FOUNDATION neither knew nor could have known that PENN CENTRAL was not creditworthy or that GOLDMAN-SACHS did not conduct an adequate credit investigation of

(2) OMISSIONS - OMITTING TO STATE A MATERIAL FACT NECESSARY TO MAKE THE STATEMENTS MADE NOT MISLEADING, i.e., "HALF TRUTHS" [10b-5(2)] OR BARE OR COMPLETE OMISSIONS AS OPPOSED TO "HALF TRUTHS" [10b-5(1) AND (3)]

The second part of Rule 10b-5(2) has reference to omissions of material fact which are required to make statements made not misleading. The statements made by GOLDMAN, SACHS were that PENN CENTRAL was creditworthy and that GOLDMAN, SACHS conducted an adequate credit investigation of PENN CENTRAL, supra. The omissions which were required to make these statements not misleading were:

1. The prime rating of the PENN CENTRAL commercial paper by NCO was based upon GOLDMAN, SACHS continuing to sell the paper and not upon an independent judgment by NCO.

2. The futile efforts of GOLDMAN, SACHS to have PENN CENTRAL increase its bankline coverage for its commercial paper from 50% to 100%.

3. GOLDMAN, SACHS sold $10,000,000 of its $15,000,000 PENN CENTRAL commercial paper inventory to PENN CENTRAL on February 9, 1970 and GOLDMAN, SACHS' imposition of a $5,000,000 inventory limit on the PENN CENTRAL commercial paper.

4. The lack of working capital, increasing losses and tight cash position of PENN CENTRAL in 1969 and 1970.

5. BROWN BROS. HARRIMAN & CO. removal of PENN CENTRAL from its list of approved issuers on February 5, 1970.

6. PENN CENTRAL was using the proceeds from the sales of its commercial paper for non-current transactions and the concern of the ICC with respect to this practice.

The factual discussion with respect to each of these omissions will particularize why it was necessary for GOLDMAN, SACHS to disclose the omitted facts in order to make the statements made not misleading.* Once this is established there is no distinction between liability for half truths under 10b-5(2) and liability for complete omissions under 10b-5(1) and (3).** Consequently the remainder of this portion of this Point will be concerned with the legal re-

*Whether a misrepresentation or omission is misleading "...may appear from its nature considered alone, or because it is not explained in a way to obviate its otherwise misleading character." Gilbert v. Nixon, 429 F. 2d 348, 356 (10th Cir. 1970).

**It is clear that Rule 10b-5(1) and 10b-5(3) impose liability for complete or bare omissions (as opposed to "half-truths"). 1 A Bromberg Securities Laws: Fraud, §2.b(2), p. 51 [1974]. Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966). See also In Re Caesars Palace Securities Litigation, 360 F. Supp. 366 (S.D.N.Y. 1973).

quirements* for the imposition of liability for an omission under 10b-5 and will presume the requisite "connection" to a statement which was made.

To be actionable under Rule 10b-5, a material fact must have been omitted. The applicable test for materiality of an omitted fact is the same as for an untrue fact, whether an investor would consider the fact important in connection with his purchase decision, supra. Thus, the Supreme Court stated in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-154 (1972):

> "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision."

See also Chasins v. Smith, Barney & Co., 438 F. 2d 1167 (2d Cir. 1970); Rochez Bros., Inc. v. Rhoades, 491 F. 2d 402 (3rd Cir. 1974); and Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F. 2d 341 (2d Cir. 1973). As will be shown, the FOUNDATION attached importance to each of the omissions and therefore the requisite (subjective)** materiality was present. The (objective) materiality of the omissions is also established by the fact that reasonable investors in general considered each omission important.

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*Materiality, scienter, reliance, lack of knowledge by the plaintiff.

**Whether the test of materiality is objective or subjective, the FOUNDATION, as a reasonable investor, satisfied both standards. In any event, the importance of the facts omitted by GOLDMAN, SACHS to the investing public in general was equivalent to that of the FOUNDATION.

The scienter requirement with respect to omissions under Rule 10b-5 is similar to that required with respect to a misrepresentation.

> "The standard for determining liability under Rule 10b-5 essentially is whether plaintiff has established that defendant ... knew the material facts that were ... omitted and should have realized their significance ... Cohen v. Franchard Corporation, 478 F. 2d 115, 123 (2d Cir. 1973).

See also, Lanza v. Drexel & Co., 479 F. 2d 1277 (2d Cir. 1973) and Rochez Bros., Inc. v. Rhoades, supra. As the factual discussions with respect to each of the omissions will show, GOLDMAN, SACHS knew each of the facts which were omitted and should have realized its significance. Therefore, the element of scienter with respect to omissions under 10b-5 was established.

In this connection, however, GOLDMAN, SACHS appears to argue that it had no duty to disclose the above omitted facts because there was no expectation by investors in the "unique" commercial paper market that such facts would be disclosed. Therefore, since it did not breach its duty of disclosure, the requisite element of scienter with respect to the omissions is lacking. Assuming, arguendo, that scienter is predicated upon (the breach of) a duty to disclose, nonetheless, the initial premise of GOLDMAN, SACHS is fallacious.

In the first instance, although there may be differ-

ences between the procedures for selling equity securities as opposed to commercial paper, such differences do not mandate that investors in commercial paper be excluded from the protection of the securities laws which specifically include and refer to commercial paper. See §3(a)(12) of the '33 Act and §3(a)(10) of the '34 Act. Indeed, such an exclusion would contravene the purpose of the federal securities laws:

> "a fundamental purpose, common to these ['33 and '34 Acts] was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus achieve a high standard of business ethics in the securities industry ...' it requires but little appreciation ... of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail in every facet of the securities industry'". SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186-187 (1963) (Citation and footnotes omitted) (Emphasis Supplied).
>
> "...Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes'". Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972).

See also J. I. Case Company v. Borak, 377 U.S. 426 (1964); Tcherepnin v. Knight, 389 U.S. 332 (1967) and Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company, 404 U.S. 6 (1971). It is for this reason that no exception should or has been made for any particular type of a security and specifically not for commercial paper. See Sanders v. John Nuveen & Co., Inc.

[1975] CCH Fed. Sec. L. Rep. ¶95,347 at 98,718 (7th Cir. 1975).

Accordingly, the scope of GOLDMAN, SACHS' duty to disclose should be defined under existing law. Under these standards, GOLDMAN, SACHS' duty is a function of its tripartite role as an underwriter, a possessor of inside information and as a dealer with respect to PENN CENTRAL commercial paper and PENN CENTRAL.

As an underwriter*, GOLDMAN, SACHS had a duty to make full disclosure of all material facts about an issuer. Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F. 2d 228 (2d Cir. 1974); Sanders v. John Nuveen & Co., Inc., supra.

Similarly, as the possessor of inside information about PENN CENTRAL, GOLDMAN, SACHS was required to disclose all material facts to investors:

> "The initial inquiry in each case is what duty of disclosure the law should impose upon the person being sued ... [Citations Omitted]. In making this determination we should bear in mind that a major congressional policy behind the securities laws in general, and the antifraud provisions in particular, is the protection of investors who rely on the completeness and accuracy of information made available to them. See 1 Bromberg, Securities Law: Rule 10b-5, §7.1 at 14 (1971). Those with greater

*Section 2(11) of the '33 Act defines an "underwriter" as follows:

> "...the term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security..."

Under this definition, there can be no doubt that GOLDMAN, SACHS was an underwriter of the PENN CENTRAL commercial paper. United States v. Abrams, 357 F. 2d 539, (2d Cir. 1966); Gilligan, Will & Co. v. S.E.C., 267 F. 2d 461 (2d Cir. 1959).

> access to information, or having a special relationship to investors making use of the information, often may have an affirmative duty of disclosure. When making a representation, they are required to ascertain what is material as of the time of the transaction and to disclose fully those material facts about which the [investor] is presumably uninformed and which would, in reasonable anticipation, affect his judgment". Kohler v. Kohler Co., 319 F 2d 634, 542 (7 Cir. 1963). A failure to perform these duties with "due diligence" in issuing registration materials provides a basis for suit under §11 of the 1933 Act, 15 U.S.C. §77k (1970). A knowing or reckless failure to discharge these obligations constitutes sufficient culpable conduct to justify a judgment under Rule 10b-5 or §14(e) for damages or other appropriate relief against the wrongdoer. SEC v. Texas Gulf Sulphur Co., supra, 401 F. 2d at 854-55." Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F. 2d 341, 363 (2d Cir. 1973).

Likewise, in Radiation Dynamics, Inc. v. Goldmuntz, 464 F. 2d 876, 887 (2d Cir. 1972), it was held that:

> "Rule 10b-5 was intended to prevent those in possession of material inside information from using that information to their own advantage when dealing with others not possessing the same information. Quite simply, one in possession of inside material information, be he an insider or a tippee, 'must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or if he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed'". (Citations omitted)

See also, Slade v. Shearson, Hammill & Co., Inc., [1974] CCH Fed. Sec. L. Rep. ¶94,329 at 95,130 (S.D N.Y. 1974); Chris-Craft Industries v. Bangor Punta Corp. [1973] CCH Fed. Sec. L. Rep. ¶93,813 at 93,495 (2d Cir. 1973); Speed v. Transamerica, 99 F. Supp. 808 (D. Del. 1951).

Finally, with respect to GOLDMAN, SACHS' role as

a dealer, the Court in Wohl v. Blair & Co., 50 F.R.D. 89, 91 (S.D.N.Y. 1970), stated:

> "The first of these policies [inherent in the anti-fraud provisions of the securities acts] is that of full disclosure by a securities dealer who recommends a transaction, which imposes a duty upon him to have an adequate basis for the recommendation and to disclose to his customer, toward whom he acts in the position of a fiduciary, all facts known or reasonably ascertainable to the customer's purchase." (Citation Omitted.)

See also, Charles Hughes & Co. v. SEC, 139 F. 2d 434, 437 (2d Cir. 1943) wherein the Court stated, "Even considering petitioner as a principal in a simple vendor-purchaser transaction ... it was under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market

Consequently, GOLDMAN, SACHS was required to disclose all material facts to a prospective purchaser of commercial paper. Moreover, such duty is not dependent upon the sophistication or knowledge of the particular investor. "Sophisticated investors, like all others, are entitled to the truth." Stier v. Smith, 473 F. 2d 1205, 1207 (5th Cir. 1973).

> "Neither Congress nor the Securities and Exchange Commission has indicated that the unsophisticated and the unwary are the only wards of Rule 10b-5. Fraud may also be perpetrated upon the powerful and the sophisticated. cf. Roquemore v. Ford Motor Co., 5 Cir. 1968, 400 F. 2d 255. Therefore, in view of the fact that gullibility is not the province of any one group, the protections and remedies of the Securities Act are not accorded only to those who fail a battery of information and intelligence tests, but are simply conditioned upon

> the misrepresentation of material facts." Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, 409 F. 2d 989, 992 (5th Cir. 1969).

In addition, a willingness to disclose is not the equivalent of disclosing and the availability of the relevant information elsewhere does not excuse non-disclosure. id.; Gilbert v. Nixon, 429 F. 2d 348 (10th Cir. 1970); Hill York Corp. v. American International Franchises, 448 F. 2d 680 (5th Cir. 1971).

Accordingly, there is no merit to the contention of GOLDMAN, SACHS that it had no duty to disclose the omitted facts cited above and therefore did not breach its duty or possess the requisite scienter for the imposition of liability for omissions under Rule 10b-5. Indeed, Judge Metzner in Franklin v. Levy clearly held that GOLDMAN, SACHS possessed such a duty.

The third element which must be established with respect to a 10b-5 omission is that of reliance. However, if an omission is material, reliance will be presumed as a matter of law.

> "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. See Mills v. Electric Auto-Lite Co., 396 US 375, 384, 24 L Ed 2d 593, 602, 90 S. Ct.

616 (1970); SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833, 849 (CA2 1968), cert. denied sub nom Coates v. SEC, 394 US 976, 22 L. Ed 2d 756, 89 S. Ct. 1454 (1969); 6 L. Loss, Securities Regulation 3876-3880 (1969 Supp. to 2d Ed of Vol. 3); A. Bromberg Securities Law, Fraud - SEC Rule 10b-5, §§2.6 and 8.6 (1967). This obligation to disclose and this withholding of a material fact establish the requisite element of a causation in fact. Chasins v. Smith, Barney & Co., 438 F. 2d, at 1172." Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-154 (1972).

See also Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F. 2d 341 (2d Cir. 1973) and Reeder v. Mastercraft Electronics Corporation, 363 F. Supp. 574 (S.D.N.Y. 1973). As indicated, supra, the factual discussions with respect to the omissions will establish that the omissions were material and, consequently, reliance was proven.

The final prerequisite for recovery with respect to an omission under 10b-5, that the plaintiff not have knowledge of the omitted facts, will similarly be established by the factual discussions. See 2 A Bromberg, Securities Law: Fraud §8.4, p. 204, 244 [1974]. The FOUNDATION neither had, nor, by the very nature of the information, could have had knowledge of the omissions of GOLDMAN, SACHS. Thus, under the circumstances, GOLDMAN, SACHS is liable for its failure to disclose the omitted facts regardless of whether such liability is predicated upon 10b-5(2) or 10b-5(1) and (3).

(3) PRACTICES WHICH ARE FRAUDULENT [10b-5(1) AND (3)

In addition to prohibiting misrepresentations, half-truths and complete omissions, Rule 10b-5 also generally proscribes "any device, scheme, or artifice to defraud"

(10b-5(1)) and "any act, practice, or course of business which operates or would operate as a fraud or deceit" (10b-5(3)) in connection with the sale of a security. Thus, the Court in Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath, [1974-75] CCH Fed. Sec. R. ¶95,090 at 97,863, 97866 (2d Cir. 1975) stated:

> "Not every violation of the antifraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'non-disclosures'. Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws.. both misrepresentations and omissions are alleged to be only one aspect of an elaborate scheme to defraud."

Similarly in A. T. Brod & Co. v. Perlow, 375 F. 2d 393, 397 (2d Cir. 1967) it was held:

> "Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities'. We believe that §10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase of sale of securities, whether the artifice employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

See also Affiliated Ute Citizens v. U.S., supra; Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company, supra; Schlick v. Penn-Dixie Cement Corp., [1974-75] CCH Fed. Sec. L. Rep. ¶94,853 at 96,871 (S.D.N.Y. 1974); 1 A. Bromberg, Securities Law: Fraud §2.6, p. 49 (1974).

For liability to be imposed for a fraudulent scheme under Rule 10b-5(1) and (3), it is only necessary to establish causation in fact:

> "However, as this Court made quite clear in the Schlick case in which the district court's dismissal of plaintiff's complaint was reversed a showing of reliance is not required where a comprehensive scheme to defraud includes not only omissions and misrepresentations, but substantial collateral conduct as well is alleged... Under these circumstances, plaintiff need only show causation in fact..." Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath, supra, at 97,866.

As the factual discussion will show, in addition to the misrepresentations of GOLDMAN, SACHS in connection with the sale of commercial paper to the FOUNDATION, supra, GOLDMAN, SACHS was also engaged in a scheme or course of business which operated as a fraud on the FOUNDATION and was causally related to the purchase. Accordingly, GOLDMAN, SACHS is liable under Rule 10b-5(1) and (3).

B. LIABILITY UNDER §12(2)

Section 12(2) of the '33 Act provides:

> "Any person who -
>
> (1) * * *
>
> (2) offers or sells a security (whether or not exempted by the provisions of section e, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which

> includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

Although the language of §12(2) is similar to that of Rule 10b-5(2), significant distinctions exist with respect to the imposition of liability. Accordingly, the legal requirements for liability under §12(2) will be set forth in this section. As with the previous analysis of Rule 10b-5, the facts in connection with §12(2) upon which the liability of GOLDMAN, SACHS is predicated are contained in the factual discussions relating to each misrepresentation and omission, infra.

Analogous to Rule 10b-5, for an action to be founded on §12(2) of the '33 Act, a false statement must be made or a fact must be omitted which is necessary to make the statements made not misleading, i.e. "half truths". The factual discussions will establish that the two statements made by GOLDMAN, SACHS concerning the creditworthiness of PENN CENTRAL and the credit investigation of GOLDMAN, SACHS were false. Similarly, it will be shown that the facts omitted

by GOLDMAN, SACHS were necessary to make these statements not misleading. In addition, however, such facts must be material. The standard for materiality under §12(2) was articulated in John Hopkins University v. Hutton, 422 F. 2d 1124, 1128-1129 (4th Cir. 1970):

> "A fact is material if it concerns information about which 'an average prudent investor ought reasonably to be informed before purchasing the security ***.' DeMarch v. Edens 390 F. 2d 836, 840 (2d Cir. 1968), citing 17 C..F.R. §230,405(1). Or, as formulated by the Restatement of Torts §538 (2)(a)(1938): 'A fact is material if *** its existence or non-existence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction in question ***.'"

See also Hill York Corporation v. American International Franchises, Inc., supra; and Gilbert v. Nixon, supra. The test for whether a fact is material is therefore the same under Rule 10b-5 and §12(2) and, as set forth in the factual discussions, the misrepresentations and omissions of GOLDMAN, SACHS were material with respect to both sections.

Unlike Rule 10b-5, however, there is no scienter requirement in connection with §12(2). Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955); John Hopkins University v. Hutton, 297 F. Supp. 1165 (D. Md. 1968); Hill York Corporation v. American International Franchises, Inc., supra. Indeed, to the contrary, under §12(2) the defendant has the burden of proving that "he did not know, and in the exercise of reason-

able care could not have known", of the misrepresentation or omission. See Thiele v. Shields, supra; Hill York Corporation v. American International Franchises, Inc., supra; and DeMarco v. Edens, 390 F. 2d 836 (2d Cir. 1968). As will be shown in the factual discussions, infra, GOLDMAN, SACHS had knowledge of the facts which were omitted and, inter alia, knew, or with the exercise of reasonable care should have known, that the statements made were false. GOLDMAN, SACHS therefore did not meet its burden of disproving liability under §12(2) with respect to the misrepresentations and omissions.

Similarly, in contrast to Rule 10b-5, reliance on or causation with respect to an omission or misrepresentation need not be established.

> "Finally, the plaintiffs need not prove that they relied in any way on the alleged misrepresentations or omissions. John Hopkins University v. Hutton, 422 F. 2d 1124, 1129 (4th Cir. 1970); Gilbert v. Nixon, 429 F. 2d 348, 359 (10th Cir. 1970).
>
> * * *
>
> A causation test should not be read into this Section [§12(2)]. A plaintiff does not have to prove that the sale would have occurred absent the misrepresentation or omission." Hill York Corporation v. American International Franchises, Inc., supra, at 695-696 (Citations Omitted).

See also DeMarco v. Edens, supra, at 841 (2d Cir. 1968)

wherein the Court stated, "Were we to support appellees' contention we would, in effect, be erroneously introducing an element of reliance into the construction of Section 12(2)." (Citations Omitted).

With respect to the last element under §12(2), the knowledge of the plaintiff, although the plaintiff must establish that he had no knowledge of the untrue statement or the omission (Hill York Corporation v. American International Franchises, Inc., supra) he is not required to investigate or prove that he could not have discovered the false statements or omissions by exercising reasonable care. Thus, in Johns Hopkins University v. Hutton, supra, at 1220-1221 (D. Md. 1968), it was held that:

> "Section 12(2), however, does not put upon the purchaser, a duty to investigate. Instead, the Securities Act "relieves the purchaser from the common law obligation of using reasonable prudence ***." Murphy v. Cady, supra, 30 F. Supp. 466 at 469. Cf. Athas v. Day, 161 F. Supp. 916-919 (D. Colo. 1958). The language of Section 12(2) makes that clear when it uses the words "not knowing of such untruth or omission" with regard to the position the purchaser must have been in at the time of purchase in order later to sustain an action under Section 12(2). Those words assume additional importance when contrasted with the use of the words, "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission" which are the words used with respect to the position the seller must have been in at the time of purchase in order later to resist liability under Section 12(2). Congress, in enacting Section 12(2), put a burden on the seller to investigate but no such burden upon the buyer. See, Restatement of Torts, §538, Comment on Subsection 3:(k), and §540 with regard to absence of

the purchaser's duty to investigate. See also Tentative Draft No. 11, April 15, 1965, of that Restatement on §540."

The factual discussions will show that the FOUNDATION did not know, indeed could not have known of the facts omitted by GOLDMAN, SACHS or that the two statements made by GOLDMAN, SACHS were untrue. Moreover, GOLDMAN, SACHS knew, or should have known the same. As under Rule 10b-5, the alleged sophistication of the FOUNDATION, the willingness of GOLDMAN, SACHS to disclose and the availability elsewhere of information not disclosed is irrelevant. See Stier v. Smith, supra; Dale v. Rosenfeld, 229 F. 2d 855 (2d Cir. 1956); Hill York Corp. v. American International Franchises, Inc., supra; and cases cited under this proposition in connection with Rule 10b-5. Accordingly, GOLDMAN, SACHS has not only violated Rule 10b-5, supra, but, in addition, is liable under §12(2).

C. LIABILITY UNDER NEW YORK GENERAL BUSINESS LAW §352-c AND CALIFORNIA CORPORATIONS CODE §§25401, 25501, 25402 AND 25502

Under §352-c of the New York General Business Law*, a private civil action for a purchaser of securities has been implied. Herzfeld v. Laventhol, Krekstein, Horwath & Horwath [1973-74] Fed. Sec. L. Rep. ¶94,574 at 95,993 (S.D.N.Y. 1974); American Bank & Trust Co. v. Barad Shaff Sec. Corp., 335 F. Supp. 1276 (S.D.N.Y. 1972); Barnes v. Peat Marwick Mitchell & Co., 69 Misc. 2d 1068 (Sup. Ct. N. Y. Co. 1972). See also People v. Cadplaz Sponsors, 69

*The text of §352-c is set forth in APPENDIX C.

Misc. 2d 417 (Sup. Ct. N. Y. Co. 1972). By comparing the language of §352-c with that of Rule 10b-5 of the '34 Act and §12(2) of the '33 Act, it is evident that liability under the federal acts will result in liability under §352-c. Under §352-c, a partnership is prohibited from practicing any fraud or deception when selling or distributing securities within or from New York. This prohibition is analogous to that of Rule 10b-5(1) and (3), supra, and therefore, since the FOUNDATION purchased the PENN CENTRAL commercial paper from GOLDMAN, SACHS in part "from" New York*, a violation of Rule 10b-5 is also a violation of §352-c. Similarly, §352-c proscribes the making of a false statement which was, or should have been, known to be false and therefore is equivalent to Rule 10b-5(2). Indeed, since the making of a false statement without making a "'reasonable' effort to ascertain the truth" (§352c(1)(c)) is prohibited, a violation of §12(2) without regard to the plaintiff's knowledge or the materiality of the misrepresentation will violate §352-c. It has also been held that scienter need not be established under §352-c. People v. Cadplaz Sponsors, supra. Section 352-c in addition proscribes the making of a representation which is "unwarranted by existing circumstances" (§352-c(1)(b)). As will be shown in the factual discussion,

*G. CLIFFORD COLEMAN, GOLDMAN, SACHS' salesman in Los Angeles, placed the FOUNDATION'S order with GOLDMAN, SACHS' New York office and the Irving Trust Company of New York sent the UNION BANK a debit advice in connection with the purchase [PX-4, 7].

infra, the representation by GOLDMAN, SACHS that PENN CENTRAL was creditworthy was not warranted under the circumstances and therefore violated §352-c, similarly without regard to materiality or the knowledge of the FOUNDATION. Finally, §352-c prohibits "concealment". Accordingly, it is analogous to Rule 10b-5(1) and (3) which impose liability for bare omissions as opposed to half truths, with the exceptions that the omission need not be material, no scienter requirement exists, and the knowledge or reliance of the plaintiff is irrelevant. Consequently, if GOLDMAN, SACHS is liable under Rule 10b-5 or §12(2), it is also in violation of §352-c. More importantly, however, the standards of Rule 10b-5 and §12(2) do not have to be satisfied for a recovery under §352-c and the FOUNDATION may recover under the New York General Business Law if the FOUNDATION merely establishes that GOLDMAN, SACHS omitted to state a fact or made a misrepresentation which was unwarranted by the circumstances. As the factual discussion will establish, the FOUNDATION has clearly met these standards for liability under §352-c (as well as Rule 10b-5 and §12(2)).

A comparison of §§25401 and 25501 of the California Corporations Code* with §12(2) of the '33 Act indicates

*The text of §§25401 and 25501 are set forth in APPENDIX D.

that a violation of the latter will be sufficient for the imposition of liability under the former if the PENN CENTRAL commercial paper purchased by the FOUNDATION was sold in California. Hughes v. Dempsey-Tegeler & Co. [1973] CCH Fed. Sec. L. Rep. ¶94,133 at 94,525 (C. D. Cal. 1973). Since the FOUNDATION placed its order with GOLDMAN, SACHS' Los Angeles office [Tr. 7-17], recovery under §12(2) will also result in liability under §25401 and §25501.

Finally, with respect to §§25402 and 25502 of the California Corporations Code*, the factual discussions, infra, will show that: (1) GOLDMAN, SACHS sold the PENN CENTRAL commercial paper to the FOUNDATION "in" California; (2) the relationship of GOLDMAN, SACHS to PENN CENTRAL gave it "access to material information about ... [PENN CENTRAL] not generally available to the public", (3) GOLDMAN, SACHS knew "material information about ... [PENN CENTRAL] gained from such relationship which would [did] significantly affect the market price of ... [the PENN CENTRAL commercial paper], (4) such material information was "not generally known to the public", (5) GOLDMAN, SACHS knew such material information was not intended to be available to the public, (6) GOLDMAN, SACHS had "reason to believe that ... [the FOUNDATION was not] in possession of the information, and

*The text of §§25402 and 25502 are set forth in APPENDIX E.

(7) the FOUNDATION would not "have purchased ... at the same price ... if the information had been revealed to ... [it]". Consequently, GOLDMAN, SACHS has also violated California Corporations Code §§25402 and 25502.

D. LIABILITY UNDER THE COMMON LAW FOR FRAUD AND INNOCENT RESCISSION

In addition to violations of federal and state securities laws, GOLDMAN, SACHS also is liable for common law fraud and innocent rescission in connection with the sale of PENN CENTRAL commercial paper to the FOUNDATION. The elements which must be established to recover for fraud under the common law are (1) the making of a false material representation or omitting to state material facts necessary to make a statement made not misleading (2) intent to deceive and (3) reasonable reliance. Reno v. Bull, 226 N.Y. 546 (1919; Arthur v. Griswold, 55 N.Y. 400 (1874); Ultramares Corp. v. Touche, 255 N.Y. 170 (1931); Ochs v. Woods, 221 N.Y. 335 (1917); Junius Construction Corp. v. Cohen, 257 N.Y. 393 (1931). In addition to misrepresentations and half truths, bare or complete omissions are actionable if the defendant has superior knowledge or stands in a position of trust. Rothmiller v. Stein, 143 N.Y. 581 (1894). The requisite intent to defraud may be inferred from knowledge by the defendant of the falsity at the time of the representation (Kuelling v. Lean Mfg. Co., 183 N.Y.

78 (1905)); from the making of a false statement recklessly, without knowledge or a genuine belief of knowledge of its truth (Ultramares Corp. v. Touche, supra; Hadcock v. Osmer, 153 N.Y. 604 (1897)); or from falsity alone (Reno v. Bull, supra, Downey v. Finucane, 205 N.Y. 251 (1912)). Reasonable reliance may be proven by establishing the materiality of the representation or omission, that the plaintiff did not know of the falsity or omissions and that the misrepresentation or omission was a substantial factor affecting the plaintiff's conduct. State Street Trust Co. v. Ernst, 278 N.Y. 104 (1938); Long v. Warren, 68 N.Y. 426 (1877); Robitzek v. Reliance Corp., 7 A.D. 2d 407 (1st Dept. 1959). As the factual discussions will establish, GOLDMAN, SACHS made material misrepresentations, material omissions and omitted to state facts necessary to make statements made not misleading with intent to defraud (or recklessly) upon which the FOUNDATION reasonably relied and with respect to which the FOUNDATION had, and could have had, no knowledge. Furthermore, GOLDMAN, SACHS had access to superior inside information and therefore had a fiduciary relationship to the FOUNDATION*. Accordingly, the FOUNDATION is entitled to rescission of the PENN CENTRAL commercial paper sale under the common law ground of fraud. Moreover, regardless of proof of intent, under the common law doctrine of innocent rescission, the FOUNDATION is entitled to rescission merely by es-

*See the discussion in the Point dealing with liability under Rule 10b-5.

tablishing that GOLDMAN, SACHS made a material misrepresentation or omission. Carr v. National Bank and Loan Company, 167 N.Y. 375 (1901); Haebler v. Crawford, 258 N.Y. 130 (1932), Ripka v. Philco Corp., 65 F. Supp. 21 (S.D.N.Y. 1945), Bloomquist v. Farson, 222 N.Y. 375 (1918); Seneca Wire & Manufacturing Co. v. A. B. Leach & Co., 247 N.Y. 1 (1928).

POINT II

THE EVIDENCE IN SUPPORT OF THE FOUNDATION'S CLAIMS UNDER THE FEDERAL AND STATE SECURITIES LAWS AND UNDER THE COMMON LAW

The legal prerequisites for the imposition of liability upon GOLDMAN, SACHS in connection with the sale of PENN CENTRAL commercial paper under the federal and state securities laws, and under the common law, have been set forth above. As indicated in such analysis, the facts upon which liability is predicated pursuant to the various legal theories are discussed in this point. The representations made by GOLDMAN, SACHS will first be considered. With respect to each representation, it will be shown, inter alia, that each:

(1) Was untrue;

(2) Was material;

(3) Was known or should have been known by GOLDMAN, SACHS to be untrue by reason of its relationship with PENN CENTRAL or was made by GOLDMAN, SACHS without confidence in its truth, was not warranted under the circumstances, or was made by GOLDMAN, SACHS with reckless disregard for its truth;

(4) Was relied upon by the FOUNDATION in connection with its purchase of the PENN CENTRAL commercial paper; and

(5) Was not known, and could not have been known, by the FOUNDATION to be false.

In connection with the omissions of GOLDMAN, SACHS, it will be demonstrated, inter alia, that with respect to each:

(1) GOLDMAN, SACHS did not disclose the fact or omission to the FOUNDATION;

(2) The omitted fact was material;

(3) The omitted fact was necessary to make the statements made by GOLDMAN, SACHS not misleading;

(4) GOLDMAN, SACHS knew the omitted fact;

(5) The FOUNDATION did not know the omitted fact.

Finally, the general fraudulent scheme or course of conduct of GOLDMAN, SACHS will be discussed. As a result, the liability of GOLDMAN, SACHS will be established under Rule 10b-5 of the '34 Act, §12(2) of the '33 Act, the state securities laws and under the common law.

A. THE MISREPRESENTATIONS OF GOLDMAN, SACHS

In connection with the FOUNDATION'S purchase of PENN CENTRAL commercial paper, GOLDMAN, SACHS stated that PENN CENTRAL was creditworthy.* In addition, inasmuch as GOLDMAN, SACHS was the dealer and underwriter of the PENN CENTRAL commercial paper, GOLDMAN, SACHS also impliedly** represented that it had a reasonable basis for its' opinion that an adequate credit investigation had been conducted:

> "The securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinions he renders. While this implied warranty may not be as rigidly enforced in a civil action where an investor seeks damages for losses allegedly caused by reliance upon his unfounded representations, its applicability in the instant proceedings cannot be questioned." Hanly v. SEC, 415 F. 2d 589, 596-597 (2d Cir. 1969).

The FOUNDATION submits, however, that PENN CENTRAL was not creditworthy as of March 13, 1970, when the FOUNDATION pur-

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*"This section of defendant's trial memorandum focuses upon the one significant statement - express or implied - which was actually made that the issuer whose commercial paper was sold by GOLDMAN, SACHS [PENN CENTRAL] was, in GOLDMAN, SACHS' opinion, creditworthy". (DTB-70)

**GOLDMAN, SACHS represented that it performed an adequate credit investigation with respect to each of its commercial paper issuers. [LEVY Dep. 246-248; WEINBERG Dep. 41]

chased, nor had GOLDMAN, SACHS conducted an adequate credit investigation. Therefore, these representations of GOLDMAN, SACHS were untrue. At the very least, these statements were unwarranted under the circumstances or made with reckless disregard for, or without confidence in, their truth.

1. GOLDMAN, SACHS MISREPRESENTED THAT PENN CENTRAL WAS CREDITWORTHY

On June 21, 1970, PENN CENTRAL filed a voluntary petition for reorganization pursuant to Chapter 77 of the Bankruptcy Act [Tr. 933]. The FOUNDATION submits that the filing of the petition creates a presumption that PENN CENTRAL was not creditworthy as of March 13, 1970, the day of the FOUNDATION'S purchase. This presumption is predicated upon a combination of the continuity presumption* and the backward relation presumption.** In McFarland v. Gregory, 425 F. 2d 433, 447 (2d Cir. 1970) the Court held:

> "The continuity presumption and the presumption of backward relation appear to be reasonable grounds on which to draw inferences where (1) a situation or the circumstances surrounding it do not go through an apparent material change and (2) the lapse of time is not great enough to suggest that unknown circumstances or causes, in the normal course of events, will have changed the situation. Each case must rest on its own bottom. It is on these terms that the better cases and commentaries have accepted these presumptions. E.g., 2 Wigmore on Evidence (3d Ed. 1940) §437 and cases collected therein ("no fixed rule can be laid down: the nature of the thing and the circumstances of the particular case must control"). These propositions are too obvious to merit extended discussions."

*MacRae v. Chelsea Fibre Mills, 145 App. Div. 588 (2nd Dept. 1911); Matter of Huss, 126 N.Y. 537 (1891); Richardson on Evidence (10th Ed. 1973) §74; (proof of the existence of a condition at a given time raises a presumption that the condition continued).

**Larsen Baking Co. v. City of New York, 292 N.Y.S. 2d 145 (2d Dept 1968).

See also U.S. v. Hamden Co-Operative Creamery Co., 185 F. Supp. 541 (E.D.N.Y. 1960). This hybrid presumption has been applied in situations practically identical to the present case. In Wilmot Engineering Co. v. Blanchard, 208 App. Div. 218 (3rd Dept. 1924), the holder of a promissory note sued the defendant issuing company for fraud based on the undisclosed insolvency of the defendant when the note was issued. The Court applied the hybrid presumption to establish the defendant's insolvency on the date the promissory note was issued. See also Bayside Mason Supplies, Inc. v. L. Barber Co., 222 N.Y.S. 2d 19 (Sup. Ct., Queens Co. 1961). Although the presumption in the Wilmot case related back only a short period of time, the Court in Mandelbaum v. Goodyear Tire & Rubber Co., 6 F. 2d 818 (8th Cir. 1925) would have applied the presumption over a three month period in the absence of significant changes during such period.

During the period between March 13, 1970, and the time when PENN CENTRAL filed its petition, there were no significant changes in the condition of PENN CENTRAL. Therefore, it may be presumed that PENN CENTRAL was not creditworthy on March 13, 1970, and that the representation of GOLDMAN, SACHS that it was creditworthy was untrue.

In Franklin v. Levy, Judge Metzner stated:

> "It is an inescapable conclusion that starting with February 4, Goldman Sachs just did not have faith in this paper any more and was lightening its load and reducing its exposure. At this point I find that the paper could no longer be considered prime paper and qualify for exemption from the provisions of Section 10(b)." (p. 19)

Accordingly, (and irrespective of whether the said hybrid presumption is applied to the facts herein*) Judge Metzner, on the same facts, with the same defendant and with the same defense counsel, determined that the PENN CENTRAL commercial paper was not prime. Similarly, Judge Brieant in Welch Foods, Inc. v. Goldman, Sachs & Co. [1974] CCH Fed. Sec. L. Rep. ¶94,806, at 96,684 (S.D.N.Y. 1974), stated:

> "Enough objective data was known concerning Penn Central in early 1970 to lead a reasonable observer to conclude that the commercial paper was not prime, and indeed the issuer became insolvent very shortly thereafter. This fact alone is some evidence that the paper was not "prime" at the time of sale. See Sanders, supra, at p. 1079 of 463 F. 2d."

A fortiori, if its commercial paper was not prime as of February 4, 1970 PENN CENTRAL could not logically be deemed to have been creditworthy thereafter.

The fact that PENN CENTRAL was not creditworthy is

*It should be pointed out that Judge Metzner did feel that it could not be assumed, solely because of the presumption, that the commercial paper was not prime. However, the FOUNDATION argues that the presumption may be utilized herein as to PENN CENTRAL not being creditworthy as of March 13, 1970.

bolstered by the evidence that PENN CENTRAL could not obtain additional banklines after having been requested to do so by GOLDMAN, SACHS on repeated occasions [See Point II(B)(2), infra]. VOGEL, who concluded that PENN CENTRAL was creditworthy [Tr. 483] and never had any doubt as to that opinion [Tr. 647], testified,

> "Q. Banklines, in making a judgment on the creditworthiness of an issuer, banklines are important, correct?
>
> A. They are not determinative as to whether a company is creditworthy.
>
> Q. But they are important, correct?
>
> A. They are not determinative. I can't answer it any other way.
>
> THE COURT: We are having a fuss about this. Your view is that this is just another person's diagnosis of the situation, in effect?
>
> THE WITNESS: No, it goes back to my original -- we are talking in terms of whether the company is creditworthy or not. I'm saying if a company is creditworthy, it will be able to get banklines or bank accommodations. If it is not creditworthy, they won't get banklines, so banklines themselves are not a determinative.
>
> THE COURT: In other words, banklines are not a cause of creditworthiness. They are a symptom of it or a result of it." [Tr. 593-594] (Emphasis Supplied)

By VOGEL'S own criterion, a company that cannot get banklines is not creditworthy. As noted, GOLDMAN, SACHS on numerous occasions had pointed out to PENN CENTRAL the importance of obtaining additional banklines if it wanted to

keep $200,000,000 in commercial paper outstanding [PX-12]. Yet, PENN CENTRAL had made it perfectly clear to GOLDMAN, SACHS that they were unable to obtain any additional bank-lines [PX-20; PX-11; PX-12; BEVAN Dep. 47; O'HERRON Dep. 31, 47, 48]. In response to questions regarding the substance of the December 9, 1969 meeting, LEPLEY of PENN CENTRAL responded [LEPLEY Dep. 51-55]:

> "A. I can't give it to you by person. The general feeling was that it would be rather difficult for us, difficult and expensive for us to arrange one hundred percent back-up lines for our commercial paper.
>
> Q. Can you state why it was the general feeling that it would be difficult for you to arrange one hundred percent back-up lines for your commercial paper?
>
> MR. GRAHAM: I object to the form of the question.
>
> A. I said it would be difficult and expensive. It would have been difficult for us to arrange one hundred percent back-up because of the bad credit market at the time. This was coming into a pretty bad credit period and the fact that the company was very heavily borrowed from its domestic banking connections.
>
> * * *
>
> Q. To return to the meeting in which you reviewed the meeting of December 9, can you tell us as best you can recall what each of Messrs. Loder, Lepley, O'Herron and Shaffer said at that review meeting?
>
> A. As best I can recall, O'Herron raised the question as to what would be our capability of raising additional back-up lines to get this up to one hundred percent. As I remember it, John Shaffer's

> response was that it would be very difficult to increase our back-up lines because of the condition of the credit market and the fact that we were already very heavily borrowed from our domestic banking sources. I don't remember any other details of that meeting."

Clearly, shortly after December 9, 1969, PENN CENTRAL did not think they could obtain additional banklines and by early February, 1970, PENN CENTRAL admitted it was unable to obtain any additional banklines [PX-12]. Thus, by VOGEL'S own standards, the admitted failure of PENN CENTRAL to obtain additional banklines establishes that it was not creditworthy.

Although VOGEL could not recall them, HOFFMAN and EVANS were the two credit analysts consecutively following PENN CENTRAL, along with many other commercial paper issuers. [EVANS Dep. 40; HOFFMAN Dep. 23]. Both the testimony of EVANS and HOFFMAN reveal that although they had been assigned to review PENN CENTRAL, they did not spend any significant time on PENN CENTRAL. Yet, even a cursory review revealed that as of December 31, 1969, PENN CENTRAL'S current liabilities exceeded current assets, PENN CENTRAL had a negative working capital, a tight cash position, an increasing debt to equity ratio, insufficient depreciation and long-term financing and a general deterioration of its balance sheet. [EVANS Dep. 58-71; HOFFMAN Dep. 35-38].

In addition, the $10,000,000 repurchase on February 9, 1970 and the $5,000,000 inventory limitation on PENN CENTRAL commercial paper [PX-12] indicate that GOLDMAN, SACHS knew that PENN CENTRAL was not creditworthy or, at the very least, had no confidence in the credit investigation it "conducted". If GOLDMAN, SACHS had not been aware of PENN CENTRAL'S financial plight or had been satisfied that its credit investigation was adequate, there would have been no reason for GOLDMAN, SACHS to decrease its inventory and place a ceiling on the inventory until such time as PENN CENTRAL, in effect, established that it was creditworthy by means of obtaining additional banklines and financings and reducing its ever-increasing losses [PX-14; Tr. 909].

By reason of all of the foregoing GOLDMAN, SACHS knew or had reason to believe, that PENN CENTRAL was not creditworthy and that accordingly the representation was untrue.

2. GOLDMAN, SACHS MISREPRESENTED THAT IT PERFORMED AN ADEQUATE CREDIT INVESTIGATION

Similarly, GOLDMAN, SACHS' representation that it conducted an adequate credit investigation was untrue. In connection with this representation, it is immaterial whether PENN CENTRAL was creditworthy or not, since if the FOUNDATION had known that GOLDMAN, SACHS had not conducted

an adequate credit investigation it would not have purchased the commercial paper [Tr. 67-69].

As to the nature of the credit investigation conducted by GOLDMAN, SACHS, WILSON testified,

> "Q. Mr. Wilson, you mentioned that you had the ultimate credit decision as part of your responsibility. Could you explain the process by which you reached a decision on credit during the period 1968, '69, early 1970?
>
> A. That is a general question, and there could be exceptions to this. But generally, a corporate finance man would ask either myself or somebody within our credit department, was company A the type of issuer that we felt from the credit point of view would be acceptable to us in the commercial paper department.
>
> That is what I would categorize as a preliminary screening. If the response was, yes, without having any discussions yet with the company or having an opportunity to see the back-up documents that we might want, we would give a general indication based on what was in our library at the time. It could be an annual report or prospectus and so on. If the indication was yes, we would then, through the corporate finance personnel, proceed to have discussions with the financial management, and ask what credit questions we felt were necessary, ask for whatever financial documents we felt were necessary. I would then be relying at this point in time on the credit department, if the situation was a continue, go, and they were interested in issuing, for them do do their own study of the issuer and satisfy themselves that it was a name that we were prepared to go on and it was creditworthy.
>
> At that point in time, if I still had not gotten any yellow lights or red lights to stop the discussions and negotiations, why, the company would pick a time to get started, and we would, I would have a review with Jack, and ask whatever questions I had at that time, and if he satisfied those, we would reach a conclusion to go ahead and start to buy paper." [Tr. 839-841]

As to the extent of the credit investigation, VOGEL testified,

"Q. Now, in performing an initial credit investigation, let's talk about Penn Central. What did you do?

A. What did I do personally?

We had, as I mentioned earlier, numerous sources of data. We had, for example, the statistical manuals which gave me background data, for example, on the two other railroads, as well as our files on both, our credit files on both Pennsylvania Railroad and the New York Central Railroad, which had been an issuer.

We have library files which basically are a catch basin for all public-type of data released either by the company or other brokerage houses might have written reports on the company or whatever, that sort of thing, annual reports going back ten years, even copies of indentures, particularly if we were a party to that particular syndicate.

I'd review -- in the case of the railroad, we had an application to the ICC for permission to issue the paper, and their approval of such, and that was part of the information I utilized in my review. The sum total of all of these sources, annual reports, both of the constituent railroads and also the one that was issued in terms of the merged railroad, covering 1967, December 31, put those all together, reviewed the railroad in terms of its assets, in terms of its -- they had, of course, the Pennsylvania Company, which, of course, is a very profitable subsidiary; they had a number of other profitable subsidiaries, and a number of security holdings, all of which gave me a great deal of confidence that they had the sources of, internal sources of financing necessary to meet any commercial paper obligation." [Tr. 481-482]

a. GOLDMAN, SACHS VIOLATED ITS DUTY OF INVESTIGATION AS AN UNDERWRITER

GOLDMAN, SACHS did not fully investigate all material facts, did not seek to independently verify such facts, did not analyze all material documents, did not seek to reconcile inconsistent actions or statements of management, did not review anything more than published data, did

not seek to examine PENN CENTRAL'S tax returns, did not request production of corporate minutes, did not meet with PEAT MARWICK & MITCHELL, PENN CENTRAL'S independent auditors nor requested production of any of their working papers. VOGEL'S purported accumulation of published material and WILSON'S demonstrated reliance on PENN CENTRAL'S repeated explanations does not satisfy the underwriter's duty of investigation as enumerated in Sanders v. John Nuveen & Co., Inc. [1975] CCH Fed. Sec. L. Rep. ¶95,347 (7th Cir. 1975).

> "An underwriter's relationship with the issuer gives the underwriter access to facts that are not equally available to members of the public who must rely on published information. And the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security. Because the public relies on the integrity, independence and expertise of the underwriter, the underwriter's participation significantly enhances the marketability of the security. And since the underwriter is unquestionably aware of the nature of the public's reliance on his participation in the sale of the issue, the mere fact that he has underwritten it is an implied representation that he has met the standards of his profession in the investigation of the issuer." Sanders v. John Nuveen & Co. Inc., supra at 98,722-3 [Emphasis Supplied]
>
> * * *
>
> "But a greater quantity of information is 'reasonably ascertainable' by an underwriter than by a mere broker, and something more than published data must be analysed if an underwriter is to discharge his duty of investigation." Sanders v. John Nuveen & Co., Inc., supra at 98,724 [Emphasis Supplied]

Similarly,

> "To effectuate the statute's [§11 of the '33 Act (footnote omitted)] purpose, the phrase 'reasonable investigation' must be construed to require more effort on the part of underwriters than the mere accurate reporting on the prospectus of 'dat[a] presented' to them by the Company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them." Escott v. Barchris Construction Corporation, 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

See also Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F. 2d 341, 370 (2d Cir. 1973).

In this connection, WILSON testified,

> "THE COURT: I think Mr. Maney is asking whether you ever asked for any documents of this kind.
>
> THE WITNESS: No, I did not.
>
> Q. Why not?
>
> A. I didn't see any need for it. I had just finished having a luncheon with the Chairman of the Finance Committee and the treasurer of the railroad and they told me what their forecasts or estimates for 1970 were going to be. So I saw no need to ask for the underlying documents and all the assumptions that would go into these figures with all the various subsidiaries and the assumptions on earnings and so on that would go into each one of those blocks that would go into this final product. No, I did not ask for it. I had the end result from the

Chairman of the Finance Committee."
[Tr. 897-898]

Under the guidelines set forth in Sanders, supra, and the foregoing cases, an underwriter, such as GOLDMAN, SACHS who fails to adequately investigate the issuer, such as PENN CENTRAL, is liable to its customers under Rule 10b-5 for resulting damage. Sanders imposes on the underwriter the mandatory duty to investigate the underlying facts supporting the published material, and notes that the underwriter's relationship to the issuer is an implicit recommendation of the issuer's security and gives the underwriter access to facts which are not equally available to customers. The Sanders decision accentuates the duty, and consequent liability, of the underwriter by indicating that the duty of investigation by the underwriter is greater than the duty imposed on the broker-dealer. Although the broker-dealer may rely upon published material, the underwriter must go beyond that and investigate the published facts since underlying facts are more reasonably ascertainable by an underwriter than by a broker-dealer. Therefore, as a matter of law, GOLDMAN, SACHS has violated its duty as an underwriter of the PENN CENTRAL commercial paper by admittedly having conducted an investigation limited to reviewing published financial information and accepting without verification, the statements of PENN CENTRAL'S management. [Tr. 481-482, 493, 549, 582, 606, 656-657, 673-674, 894, 896-

899, 937, 970, 981-982, 993-996, 1015, 1024].

b. GOLDMAN, SACHS OVERSTATED THE VALUE OF PENN CENTRAL ASSETS BY $1,500,000 IN ITS CREDIT INVESTIGATION

VOGEL, as the person in charge of the commercial paper credit department [Tr. 468], conducted approximately 90% to 95% of the PENN CENTRAL credit investigation himself [Tr. 556] primarily because he viewed it as an unusual situation [Tr. 557]. VOGEL did not request HOFFMAN or EVANS to update the PENN CENTRAL credit investigation [Tr. 561, 563]. [EVANS Dep. 50-53; HOFFMAN Dep. 25]. VOGEL stated, as part of his conclusion as to creditworthiness of PENN CENTRAL, that:

> "Again, we are talking about a railroad that had total assets somewhere in the neighborhood of $6 Billion worth of assets on their balance sheet..." [Tr. 493].

See also, Tr. 663. Yet VOGEL* admitted that he was aware of the PENN CENTRAL application to the Interstate Commerce Commission which contained O'HERRON'S letter [PX-67] wherein O'HERRON stated

> "It is submitted that an aggregate of $450 [footnote omitted] Million in short term maturities, of which $300 Million can be refunded into a term loan, pursuant to an existing agreement

*VOGEL indicated he probably read O'HERRON'S letter although he could not say with certainty [Tr. 657-665]. WILSON testified he was also familiar with PENN CENTRAL'S application to the ICC [Tr. 967].

> and an authorization heretofore granted by the Commission, is not excessive when related to Penn Central Transportation Company's assets of approximately $4.5 Billion." [PX-67]

In addition, PENN CENTRAL'S application to the Interstate Commerce Commission [PX-68] revealed that the transportation company, the commercial paper issuer, had only $4.5 Billion in total assets.

O'HERRON testified:

> "Q. In other words, it states here, for the benefit of everybody who is here:
>
> "Jon said that if we are to consider the relationship of $200,000,000 in commercial paper to a total assets structure of some four and a half billion, it really is a small amount."
>
> Let's take the four and a half billion in assets. Did Mr. Wilson, to your knowledge, or anyone else from Goldman, Sachs ask about what part of the four and a half billion in assets was mortgaged, pledged, or otherwise used for securities?
>
> MR. MANEY: I object to the form of the question.
>
> A. I don't recall." [O'HERRON Dep. (April) 50].

Despite the fact that Messrs. VOGEL and WILSON utilized the $6,000,000,000 figure in concluding that the PENN CENTRAL TRANSPORTATION COMPANY was creditworthy [Tr. 493, 855], the assets of the parent holding company, PENN CENTRAL COMPANY, were not made available to the holders of commercial paper of the transportation company, nor did WILSON know

whether those assets would be made available at the time he was relying upon those assets for his conclusion [Tr. 997].

c. GOLDMAN, SACHS' CREDIT INVESTIGATION TECHNIQUES WERE PERFUNCTORY AND INADEQUATE

The evidence at trial reveals that GOLDMAN, SACHS did not conduct a reasonable, adequate or meaningful credit investigation either initially or on any continuing basis.

Clearly, it is insufficient for the underwriter to merely rely on published material or statements of management. Sanders v. John Nuveen & Co., Inc., supra. Yet, the GOLDMAN, SACHS credit investigation consisted of accumulating documents such as newspaper articles, press releases, authorizations to issue commercial paper from the PENN CENTRAL Board of Directors, signature cards, rating agency manuals, annual reports and prospectuses [Tr. 841, 481-482; EVANS Dep. 40-43; HOFFMAN Dep. 14-15]. This material was maintained in the GOLDMAN, SACHS library files [Tr. 482]. The testimony of VOGEL, WILSON, HOFFMAN and EVANS revealed that no effort was made to investigate any further than reviewing these accumulated materials and relying upon PENN CENTRAL'S repeated expressions of confidence. [HOFFMAN Dep. 19-20]. VOGEL, who performed practically the entire credit investigation on PENN CENTRAL [Tr. 556] could not recall any contact with PENN CEN-

TRAL management [Tr. 508] other than what was reflected in the blue sheets. HOFFMAN testified at deposition that he was the only credit analyst working on PENN CENTRAL after January, 1970 and that as to the "continuing credit investigation" he did nothing other than preparing a review of the 1969 financial statements and reading newspaper articles [HOFFMAN Dep. 23]. WILSON, however, who did have access to PENN CENTRAL management, merely accepted at face value what he was told. WILSON did not request the written budget documents or the financial projections [Tr. 895-897] although he conceded that he had no basis for believing that such documents would not be produced upon request.

> "THE COURT: Let me ask this: Did you ever have any reason to believe in the course of your dealings with PENN CENTRAL that if you asked them for any document or material, reasonably necessary for purposes that you were responsible for, that they would refuse to give it to you?
>
> THE WITNESS: I do not believe so, no." [Tr. 995-996]

WILSON did not request any substantiation of any reports or projections [Tr. 898] and seemingly relied wholly on the representations of PENN CENTRAL.

> "THE COURT: Mr. WILSON, yesterday I asked what information you might have had or was asked for that would have enabled you to foresee the seriousness of the situation that you didn't have.
>
> THE WITNESS: It's very hard for me to think of any because of the contacts that I had with the senior financial officers of the railroad, right

> on through this February, March, April, May, June period that did not give this picture." [Tr. 937]

After WILSON learned of the 1969 losses, at which he was surprised and disturbed [Tr. 987-988], he merely relied once again on the explanations furnished by PENN CENTRAL without any further investigation.

> "Q. If anyone had requested BEVAN or O'HERRON to provide financial budget documents they were referring to in early 1970, would they have refused to provide you with those documents?
>
> A. Would they have refused?
>
> Q. Yes.
>
> A. At that time, I don't know whether they would have or not because I didn't ask for them. I didn't think there was any need to ask for them. I was talking to the chairman of the finance committee --" [Tr. 995].

Furthermore, WILSON relied (as did VOGEL [Tr. 646]) on the December 1969 debenture prospectus [Tr. 945], did not inquire of PENN CENTRAL as to what purpose the commercial paper proceeds were to be used [Tr. 970], never asked PENN CENTRAL whether it had been denied any banklines [Tr. 994] and in connection with the $16,000,000 loss for the fourth quarter of 1969, relied upon PENN CENTRAL'S explanation rather than inquiring of PENN CENTRAL'S independent auditors [Tr. 1015].

As noted, the credit investigation was the responsibility of the commercial paper credit department [Tr. 479] a credit investigation that was intended to be an ongoing investigation as to the creditworthiness of P. C. CENTRAL [Tr. 479], yet an investigation that produced only two written reviews [Tr. 471; HOFFMAN Dep. 32; EVANS Dep. 62; PX-39, PX-40 for identification.] VOGEL was in charge [Tr. 468] and had four credit analysts working for him [Tr. 470]. Each analyst had approximately fifty (50) issuers to investigate and follow on a day-to-day basis [Tr. 630; HOFFMAN Dep. 8] However, GOLDMAN, SACHS did not maintain any training program for the credit analysts [Tr. 627] nor had any written guidelines been adopted as to how the credit analysts were to perform their duties [Tr. 627]. Neither VOGEL nor the credit analysts had any significant contact with PENN CENTRAL management [Tr. 582; HOFFMAN Dep. 21; EVANS Dep. 30]. Bank checkings were conducted by part-time college students [Tr. 633]. Although there can be no doubt that GOLDMAN, SACHS understood that the transportation company was the issuer of the commercial paper (and not the holding company) the creditworthy conclusion was based upon the complete PENN CENTRAL complex.

VOGEL testified that the initial credit review of PENN CENTRAL took as long as six to eight months to "com-

plete" [Tr. 506].* VOGEL, however, did not retain any analyses, computations or other documents that may have been prepared during that period of time, and, in fact, no written report was made of that initial credit investigation [Tr. 492]. Although VOGEL attempted to explain the manner in which he computed the extent of the encumbrances upon PENN CENTRAL assets, he admitted that it was not until April, 1970 that GOLDMAN, SACHS inquired as to the existence of liens upon the New York City real estate properties and hotels [Tr. 490; PX-16]. In addition to the fact that VOGEL testified that he threw his "computations" away [Tr. 506]**, his credit investigation did not truly focus upon the liquidity of PENN CENTRAL assets [Tr. 574]. In connection with VOGEL'S evaluation*** of the encumbrances, he testified [Tr. 646] that he relied heavily on the December 1969 debenture offering prospectus [PX-63] as did WILSON [Tr. 945]. Yet, that document did not reveal the extent or nature of the asset encumbrances. No effort was made to request or examine any mortgage or pledge instruments, or any other underlying documents.

According to VOGEL it was the GOLDMAN, SACHS policy that renewed credit investigations are conducted each time an

*Although VOGEL was unable to quantify the amount of time he spent on the initial credit review [Tr. 506], he demonstrated a remarkable ability to recall certain facts, e.g. specific sheets out of Moody's Manual [Tr. 488-489], but was unable to recall basic information such as the names of the credit analysts assigned to PENN CENTRAL [Tr. 475, 560].

**It would appear logical that preserving one's notes and computations would make each subsequent review more efficient.

***According to VOGEL the "evaluation" was based only on estimates [Tr. 495].

existing issuer issues additional commercial paper [Tr. 642]. Yet, in March, 1969 when PENN CENTRAL applied to increase its commercial paper outstandings to $150,000,000 and in September, 1969 to $200,000,000 no additional credit review was conducted [Tr. 599, 643].

Similarly, when O'HERRON stated in September, 1969 that:

> "John also pointed out that the company will be in a very tight cash position in the first quarter of 1970 and asked if we could put out as much paper as possible in April or longer " [PX-20].

VOGEL did not pursue any further inquiry of PENN CENTRAL'S creditworthiness [Tr. 579]. It was at that same meeting [PX-20] that VOGEL testified, he "eyeballed" O'HERRON and was quite impressed with him [Tr. 518-519]. Yet, on February 4, 1970, when O'HERRON'S prediction proved erroneous (that the fourth quarter of 1969 would be in the black [PX-33]), neither VOGEL nor WILSON altered their opinion of O'HERRON or in any way ceased their complete reliance upon management assurances [Tr. 548, 656, 673-674, 990, 993]. Both WILSON and VOGEL'S testimony appears incredible in view of WILSON'S testimony as to how he was continually "jousting" with O'HERRON [Tr. 877, 910, 953] in connection with the obtaining of banklines and limiting inventory and WILSON'S testimony that when BEVAN and O'HERRON told him on

February 6, 1970 [PX-12] that they did not feel they could obtain additional banklines, WILSON did not believe them! [Tr. 894]. It is indeed curious, if that was in fact true, why WILSON did not record that in the Blue Sheet [PX-12]. Clearly, if he thought that they were not being straightforward with him, certainly other information provided by PENN CENTRAL should have been independently verified. If he did in fact believe that PENN CENTRAL could not obtain banklines, then, of course, further inquiry was required. This, however, was not done.

Further evidence of the inadequate credit investigation of GOLDMAN, SACHS is the fact that in March 1969, VOGEL learned that (a) Continental Insurance Company had removed PENN CENTRAL from its approved list of issuers of commercial paper [PX-42]; (b) in October 1969, Mr. HUGH COX, counsel to PENN CENTRAL, advised the ICC that PENN CENTRAL was experiencing difficulties with the effects of the merger [PX-28] and (c) in February 1970, BROWN BROS. had removed PENN CENTRAL from its approved list of issuers of commercial paper [PX-12]. Despite this knowledge, at no time did GOLDMAN, SACHS investigate the Continental Insurance Company matter [Tr. 932], the HUGH COX statements [Tr. 953], or the BROWN BROS. decision [Tr. 956-957]. On February 6, 1970, O'HERRON asked WILSON to attempt to arrange

a meeting between O'HERRON and BROWN BROS. to determine why BROWN BROS. had removed PENN CENTRAL from its approved list [PX-12, Tr. 956]. WILSON arranged for GOLDMAN, SACHS to contact an officer on the BROWN BROS. trading desk who indicated that the meeting should not occur because he (the desk officer) did not want to be caught between the contradictory positions of BROWN BROS., i.e. eliminating PENN CENTRAL from its approved list and extending PENN CENTRAL a $2,000,000 line of credit [Tr. 956-957]. Accordingly, on February 12, 1970, WILSON told O'HERRON that BROWN BROS.

> "...did not wish to meet with ... [O'HERRON] to review the 1969 figures as they felt it would be awkward. JOHN O'HERRON ... agreed not to make any out-of-the-ordinary reviews with them so as not to jeopardize our [GOLDMAN, SACHS'] relationship with BROWN BROS. ...." [PX-12]

Although neither GOLDMAN, SACHS or PENN CENTRAL confirmed the obvious reason for BROWN BROS. removing PENN CENTRAL from its approved list,* it is clear that the relationship between BROWN BROS. and GOLDMAN, SACHS which O'HERRON agreed not to "jeopardize" would certainly have enabled GOLDMAN, SACHS to do so, as is indicated by the testimony of LEVY [Tr. 831]:

> "THE COURT: If you wanted information from BROWN BROS. HARRIMAN about an account, could

*Once again, VOGEL thought the BROWN BROS. HARRIMAN development to be of no credit significance [Tr. 546].

GOLDMAN, SACHS get in touch with them?

THE WITNESS: Absolutely."

On February 5, 1970, when GOLDMAN, SACHS learned of PENN CENTRAL'S fourth quarter losses [PX-11] both WILSON and VOGEL were surprised and disturbed [Tr. 987-989]. WILSON immediately called LEVY in St. Louis and JAMES HEMPHILL [Tr. 984-986] in Chicago and requested LEVY to arrange a meeting with PENN CENTRAL* for February 6, 1970 [Tr. 991], to answer serious questions, a meeting which WILSON, under normal circumstances, had the authority to schedule alone. Although WILSON had indicated that after that meeting his concern was alleviated (the purpose for the meeting) such testimony is highly incredible in light of the fact that the day prior to such "reassurance" meeting, WILSON had told O'HERRON [PX-13] and VOGEL had told ALAN ROGERS of NCO [PX-10]** that GOLDMAN, SACHS would continue to sell commercial paper of PENN CENTRAL. Clearly, GOLDMAN, SACHS had decided prior to the February 6, 1970 meeting, to continue with the sale of the PENN CENTRAL commercial paper, regardless of what transpired at the meeting. These facts lead to the inescapable conclusion that GOLDMAN, SACHS did not conduct an adequate credit investigation and had, for reasons of their own, become committed to their continued

*In order to make sure that BEVAN, Chairman of the Finance Committee would attend [Tr. 991].

**VOGEL'S "opinions" can most kindly be characterized as inconsistent. He testified he considered ROGERS one of the finest men he knew [Tr. 529] and that VOGEL "looked up to ROGERS" as a credit man [Tr. 529], yet VOGEL testified that ROGERS' expressed concern about PENN CENTRAL had no effect whatsoever on VOGEL'S opinion as to creditworthiness.

sale of PENN CENTRAL commercial paper.*

It should also be noted that in conducting their credit investigation, GOLDMAN, SACHS relied on the extension of credit by certain banking institutions [Tr. 523, 864] and on the Interstate Commerce Commission's approval of increases in the outstanding PENN CENTRAL commercial paper [Tr. 967]. To the extent GOLDMAN, SACHS urges such actions by the banking institutions and Interstate Commerce Commission as substantiation of its own credit investigation, such a position is inappropriate. Reliance of this nature by GOLDMAN, SACHS does not satisfy its' duty of investigation,

> "Nuveen forcefully argues that its reliance on the Lieber, Bleiweis audits was reasonable because the leading banks in the country, which had extended millions of dollars of credit to WH over a period of many years, also relied on the same information (or misinformation). There are two answers to this argument. First, the reasonableness of a bank's credit investigation procedures is not before us and is not to be judged under the standards of the Federal Securities Acts; we are concerned only with the duty of the underwriter to comply with requirements of statutes and regulations designed to protect the investing public. Second, even if we should assume that the banks are subject to the same standards as an underwriter, the fact that their practices may have been considered acceptable by the banking industry would not convince us that they meet the standards imposed by the relevant statutes and regulations." Sanders v. John Nuveen & Co., Inc. [1975] CCH Fed. Sec. L. Rep. ¶95,347 at 98,723 (7th Cir. 1975). [Emphasis Supplied]

Similarly, as Judge Metzner stated in Franklin v. Levy,

*Although they expeditiously took care of reducing their own inventory [PX-12].

> "Defendants also rely on the Interstate Commerce Commission's report, after a full investigation, approving the increase from $150 Million to $200 Million in the amount of commercial paper that the Penn Central could have at any one time. It noted that the issuer was in a strong financial condition. However, this approval was issued in October 1969, too remote in time to be relied on in this case. We are talking about six months later in what appears to have been fast moving events in Penn Central's financial picture. Furthermore, the permission was predicated on Penn Central's representation that it would obtain long-term financing as soon as the tight money market eased." (p. 13)

Additionally, Judge Brieant in Welch Foods, Inc. v. Goldman, Sachs & Co., supra, at 96,684, stated:

> "Defendant's contention that grant of authority for issuance by the Interstate Commerce Commission ("ICC") has some evidentiary value in determining whether or not the notes were "prime" within the Zeller criteria, lacks merit."

Lastly, GOLDMAN, SACHS' failure to adequately inquire into PENN CENTRAL'S creditworthiness, is demonstrated by GOLDMAN, SACHS' obvious lack of concern as to PENN CENTRAL'S use of its commercial paper proceeds [See Point II B 6, infra].

It is submitted that the foregoing facts establish that the purported credit investigation performed by GOLDMAN, SACHS was, by prevailing standards, woefully deficient. It was based on facts supplied by PENN CENTRAL management but not indepen-

dently verified by GOLDMAN, SACHS. Inconsistent statements by PENN CENTRAL management were not reconciled. Adverse financial information regarding PENN CENTRAL did not prompt review or re-evaluation. Gross errors were made and significant facts overlooked by GOLDMAN, SACHS in analyzing PENN CENTRAL'S financial condition. Finally, little*, if any, written analysis exists with respect to the credit investigation of one of the largest corporations in the United States and therefore whether an investigation actually occurred depends upon the questionable credibility of GOLDMAN, SACHS' witnesses. It is entirely appropriate to conclude that the credit investigation by GOLDMAN, SACHS of PENN CENTRAL was inadequate and that GOLDMAN, SACHS' representation to the contrary was false.

It is beyond dispute that the creditworthiness of PENN CENTRAL and the fact that GOLDMAN, SACHS conducted an adequate credit investigation were material facts as defined, supra. Thus, LeMAY testified he assumed GOLDMAN, SACHS' had made a credit investigation of PENN CENTRAL [Tr. 67]. Reliance on these facts is similarly beyond question as indicated by LeMAY'S statement that if the PENN CENTRAL commercial paper was "good enough for GOLDMAN, SACHS [it was] good enough for us" [Tr. 69]. Moreover, by virtue of the fact that it

*The only documents resembling an analysis are the two annual reviews (PX-39, PX-40 for identification) which were nothing more than a summary and analysis of the PENN CENTRAL annual reports and financial statements.

purchased the commercial paper the FOUNDATION did not know, and indeed could not have known, that PENN CENTRAL was not creditworthy or that GOLDMAN, SACHS had performed an inadequate credit investigation. In contrast, however, GOLDMAN, SACHS either knew, or if it had performed a reasonable credit investigation, would have known, that PENN CENTRAL was not creditworthy and, knew that it had not performed an adequate investigation. At the very least, the superficial nature of the credit investigation by GOLDMAN, SACHS renders its representation that PENN CENTRAL was creditworthy one which was made, either with reckless disregard for whether it was misleading, or, as will be shown in connection with the factual discussions of the omissions, infra, a statement in which GOLDMAN, SACHS had no confidence. As Judge Metzner determined,

> "It is an inescapable conclusion that starting with February 4, Goldman, Sachs just did not have faith in this paper any more and was lightening its load and reducing its exposure." (p. 19)

B. THE OMISSIONS OF GOLDMAN SACHS

1. GOLDMAN, SACHS DID NOT DISCLOSE THAT THE PRIME RATING OF THE PENN CENTRAL COMMERCIAL PAPER BY NCO WAS BASED UPON GOLDMAN, SACHS' DECISION TO CONTINUE TO SELL IT AND NOT UPON NCO'S INDEPENDENT JUDGMENT

The evidence shows that GOLDMAN, SACHS represented that the PENN CENTRAL commercial paper it sold to the FOUNDATION was rated "Prime" by NCO and that the FOUNDATION relied on that representation and would not have purchased the commercial paper without it. The evidence further establishes that the FOUNDATION was unaware of ROGERS' statement (in PX-10) to VOGEL and that the failure to disclose either the truth of the statement or the making of the statement was a material omission.

A. NONDISCLOSURE OF THE TRUTH OF ROGERS' STATEMENT

LEMAY's testimony that GOLDMAN, SACHS' Los Angeles office represented to him that the PENN CENTRAL commercial paper he was buying on March 13, 1970 on behalf of the FOUNDATION was rated prime* by NCO [Tr. 7, 8, 13, 14,

*The testimony of LEMAY and FITZPATRICK leaves open the possibility that GOLDMAN, SACHS may have represented the PENN CENTRAL commercial paper as "prime" meaning "excellent quality", "first in value" or the like as opposed to NCO's rating of the paper as "Prime". Indeed, DUERSON testified that "Prime means quality paper." [DUERSON Dep. 97]. In the event the Court finds that GOLDMAN, SACHS made an express representation on March 13, 1970 that the PENN CENTRAL commercial paper was prime (as opposed to NCO prime) it is clear from the holdings in Welch and Franklin v. Levy that this representation was material and untrue.

59-61] was not controverted. The three salesmen in the Los Angeles office of GOLDMAN, SACHS with whom LEMAY dealt testified at their depositions as follows:

> 1. FREDERICKSEN (who was also the Sales Manager of GOLDMAN, SACHS' Los Angeles office) testified that he had dealt with LEMAY for ten years, that he did not "think" that during that time he sold LEMAY anything but prime commercial paper, that he did not handle the FOUNDATION transaction, that COLEMAN and DUERSON also dealt with LEMAY and that he "believes" COLEMAN handled the FOUNDATION'S purchase on March 13, 1970 [FREDERICKSEN Dep. 90, 91, 92];
>
> 2. DUERSON testified that he dealt with LEMAY but that he did not participate in the March 13, 1970 transaction [DUERSON Dep. 45, 46]; and
>
> 3. Coleman testified that he sold only NCO prime paper to the UNION BANK [COLEMAN Dep. 112], that he understood that the UNION BANK was only interested in prime commercial paper [COLEMAN Dep. 113, 114] and that on the date of the subject purchase he took the order for PENN CENTRAL commercial paper from LEMAY by telephone and "presumes" that there was a prior conversation between LEMAY and someone else at the Los Angeles office of GOLDMAN, SACHS in connection with the paper because LEMAY already knew what he wanted when he called him [COLEMAN Dep. 114, 115, 116].

PENN CENTRAL announced its 1969 losses on February 4, 1970. On February 5, 1970 VOGEL <u>received</u> a telephone call from ALLAN ROGERS, NCO's "senior analyst" [Tr. 529]. ROGERS was one of the "finest men" VOGEL had ever met, had more experience than VOGEL as a credit man and there was

"absolutely no doubt as to his integrity ..." [Tr. 529-30]. VOGEL testified that he had "frequent" telephone conversations in early 1970 (and previously) with ROGERS, on many issuers including PENN CENTRAL [Tr. 530, 531, 639, 640]. VOGEL, however, reduced only one such telephone conversation to writing [Tr. 639, 640]. This was the telephone conversation on February 5, 1970 which is the entire subject of VOGEL's Blue Sheet of that date [PX 10]:

"February 5, 1970

> Alan Rogers of NCO called me today to express concern over the sharply reduced earnings announced in the newspapers today. He asked if we were continuing to sell the Company's notes and whether I felt that Penn Central had sufficient resources which could be converted to cash to pay down debt if necessary. I said that Goldman, Sachs was continuing to sell the commercial paper notes of Penn Central Transportation Company. In answer to question number 2, I suggested that the Company has a number of valuable properties and securities, and that I was certain that something could be worked out should it ever become necessary.
>
> Alan said that as a result of my comments, he would continue to carry Penn Central Transportation Company as a prime name.
>
> JACK A. VOGEL
>
> cc: GLL, JCH, JLW, RGW, GVC, LED, PAF" (Emphasis Supplied).

VOGEL's entire recollection of the February 5, 1970 conversation is recorded in PX-10 [Tr. 540].

VOGEL's testimony (objected to by the FOUNDATION [Tr. 541]) of his interpretation of PX 10 is simply not believable:

> "I intended to convey the fact that as a result of GOLDMAN, SACHS' continuing to market commercial paper of the PENN CENTRAL that Alan Rogers, or NCO would have to, have to continue to either rate it or pull its rather [sic], whatever their choice may be at the time. That's what I intended to convey. ....
>
> The fact that we were handling the paper made it it imperative that they continue their own investigation." [Tr. 541, 542]

Thus, after hearing that distorted testimony, the Court commented:

> "Well, that isn't what you said here, though. You said -- if you read the last sentence, you say, 'that as a result, you are continuing to carry Penn Central as a prime name'." [Tr. 542]

In Franklin v. Levy (but not here) GOLDMAN, SACHS offered the similarly distorted interpretation of PX-10 by LEVY:

> "... if we [Goldman, Sachs] continued to sell, he [NCO] would continue to rate it. If we stopped selling, there would be no reason for him to rate the paper." [FSB Tr. 803]

In setting forth his contrary understanding, Judge Metzner advised GOLDMAN, SACHS' counsel that "Mr. LEVY is free to say what he thinks it meant to him. I am telling you what it meant to me when I saw the original note," (Ibid., p.803) and noted that, "the only trouble with Goldman, Sachs' position is that the rating organization [NCO] appears to have continued the prime rating on February 5 in reliance on

defendant's decision to continue to sell this paper despite adverse news as to the financial condition of Penn Central." (p. 12).

Mr. WILSON who thought the VOGEL-ROGERS conversation was sufficiently important to repeat to PENN CENTRAL at the February 6, 1970 luncheon apparently adopted the plain meaning interpretation of this Court and Judge Metzner when, on February 6, 1970, he told PENN CENTRAL:

> "I also explained Allen Rogers' conversation with Jack Vogel and Allen's feeling that as long as Goldman, Sachs was going to continue to handle Penn Central's c/p he would keep the Prime rating." [PX 12]

Thus the prime rating which NCO gave PENN CENTRAL commercial paper was not predicated upon an independent judgment by NCO or an analysis of PENN CENTRAL's financial condition. Rather, it was based upon the fact that GOLDMAN, SACHS decided to continue to sell PENN CENTRAL's commercial paper. In this connection, it is significant that GOLDMAN, SACHS did not inform ROGERS, or anyone else at NCO, of the other omissions (e.g. banklines, BROWN BROS., inventory reduction and limitation). Similarly, in selling PENN CENTRAL commercial paper to the FOUNDATION, GOLDMAN, SACHS did not disclose NCO's reliance in rating the PENN CENTRAL commercial paper as prime upon GOLDMAN, SACHS' advice that it was continuing

to sell the paper. Thus, LeMAY testified that he did not know of this fact and had he known would not have "shown" the paper to the FOUNDATION [Tr. 39-40]. Accordingly the omission is material.

GOLDMAN, SACHS may however argue that ROGERS' statement that NCO would continue to rate PENN CENTRAL "as a prime name" as a result of VOGEL's comments is hearsay and therefore not admissible to prove the truth of its contents, i.e. that NCO was in fact continuing to rate PENN CENTRAL commercial paper as prime because of what VOGEL had told ROGERS on February 5, 1970. However, this evidentiary issue must be resolved against GOLDMAN, SACHS.

At trial, the FOUNDATION clearly indicated that it was offering PX-10 for the truth of ROGERS' statement [Tr. 139-40]. The Court noted that it "wouldn't think ... [GOLDMAN, SACHS would] object to" that but stated that it would take up the objections [to this and other documents] "one by one and . . . rule on . . . [them]" [Tr. 140, 141]. No objection was made by GOLDMAN, SACHS to the introduction of PX-10 to prove the <u>making</u> of the statement by ROGERS. GOLDMAN, SACHS then requested that PX-10 and other documents, with respect to which it preserved an objection to the use of

the statements as proof of their truth [Tr. 142, 143] "be received in evidence subject to subsequent ruling by the Court on this point" [Tr. 142]. Thereafter, the Court stated:

> "... First I want to state for the record that all of the exhibits heretofore discussed to which defense counsel has indicated either it has no objection or that it has no objection but requests a limiting order as indicated, and Exhibits 71 and 117, are admitted in evidence." [Tr. 144, 145]

This clearly demonstrates that the Court was postponing a decision on GOLDMAN, SACHS' request for a limited ruling until such time as the issue needed to be resolved.

The first opportunity GOLDMAN, SACHS had thereafter to request a determination as to whether PX-10 should be subjected to a limited ruling was when GOLDMAN, SACHS questioned VOGEL about PX-10 [Tr. 536-542]. At no time during this direct examination (or thereafter) did GOLDMAN, SACHS ask the Court to rule that PX-10 had been admitted into evidence for a limited purpose. In fact, over objection from the FOUNDATION [Tr. 540, 542], GOLDMAN, SACHS elicited VOGEL's testimony as to what ROGERS <u>meant</u> by his statement:

> "Q. [by Mr. MANEY] What was your understanding of Mr. ROGERS' comment that he would continue to carry PENN CENTRAL as a prime name?
>
> * * *

Q. Mr. VOGEL, would you look at the last sentence of your memorandum, PX 10, the sentence beginning 'Alan said'. Do you have that?

A. Yes.

Q. What does that mean?" [Tr. 540]

Therefore, GOLDMAN, SACHS itself placed the truth of ROGERS' statement in issue. It never requested or received a limiting instruction with respect to PX-10 and consequently it has waived whatever right it may have to object to ROGERS' statement as hearsay and cannot now be heard to claim any such limitation on the Court's consideration of this evidence.

Furthermore, the admission of ROGERS' statement to prove the truth of its contents is unobjectionable because it is (1) part of a business record (Fed. Rules Ev. 803(6)) and (2) a declaration against interest (Fed. Rules Ev. 804(b)(3)).

PX-10, a Blue Sheet in GOLDMAN, SACHS credit file [DX-A], was conceded by GOLDMAN, SACHS to be a business record [Tr. 137]. The basis for the objection raised by GOLDMAN, SACHS, to the admission of ROGERS' statement as part of a business record to prove its truth was that ROGERS "had no duty to report [to] the author of the memorandum" [Tr. 137-138], i.e. VOGEL. However, GOLDMAN, SACHS' position is factually incorrect.

At the time of the making of the statement, ROGERS was the senior analyst of NCO [Tr. 528-529] and NCO was in the business of evaluating and rating commercial paper [Tr. 528-529] and selling its services to subscribers in the investment community, one of which was GOLDMAN, SACHS. GOLDMAN, SACHS was a seller of commercial paper and VOGEL was the head of its credit department whose responsibility it was to insure that the issuers of the commercial paper it sold were creditworthy. ROGERS called VOGEL "regularly" to report on such matters. The Court itself in a question to VOGEL stated:

> "THE COURT: Did the fact that your old pal, Mr. ROGERS, who was so important in the rating of paper and the paper of your issuer, felt it necessary to call you to express his concern seem to you a factor that you should take into consideration in determining or reassessing PENN CENTRAL'S creditworthiness?" [Tr. 539] (Emphasis supplied).

VOGEL testified in response to this question that had ROGERS expressed concern to him about the creditworthiness of PENN CENTRAL, VOGEL "would have spent a great deal of time asking the reasons why" [Tr. 539], implying that ROGERS was under a duty to supply such information to VOGEL as part of the subscription service offered by NCO to GOLDMAN, SACHS. It is well known that the business of credit rating services is to supply to their subscribers a rating and upon request, the reasons for that rating. See e.g. Munro v. The Bradstreet

Company, 170 App. Div. 294 (1st Dept. 1915). Accordingly, ROGERS was under a duty to disclose to VOGEL, the head of its subscriber's credit department, the basis for NCO's carrying or intention to carry PENN CENTRAL paper as "prime" rated. ROGERS' statement that "as a result of [VOGEL's] comments [that GOLDMAN, SACHS was continuing to sell the paper], [NCO] would continue to carry PENN CENTRAL TRANSPORTATION COMPANY as a prime name" was thus clearly made under a business duty to the recorder of the statement (VOGEL) who concededly recorded the statement as part of his business duty [Tr. 137]. The statement is therefore admissible for its truth under the business records exception to the hearsay rule. Fed. Rules Ev. 803(6). See e.g. Pekelis v. Transcontinental & Western Air, Inc., 187 F. 2d 122, 131 (2d Cir. 1951) where it was held that an airline's investigation boards' reports were admissible as to statements made not only by the airline's employees, but also by airport employees and Irish government employees, as the latter were under a duty to report to the boards as part of their employment.*

It is equally clear that ROGERS' statement qualifies as a declaration against interest because ROGERS was unavailable at trial due to his death some years earlier [Tr. 529]

*It is also arguable that Fed. Rule 803(6) adopted in the House version deleting the requirement that the recorded information be "transmitted ... in the course of a regularly conducted activity" [Proposed Rules 803(6)], intended to adopt Wigmore's more liberal view that the absence of a business duty on the part of third party informants whose statements appear in business records goes only to weight and not admissibility of the statements. See Pekelis v. Transcontinental & Western Air, Inc., supra at 130-31.

Fed. Rules Ev. 804(b)(3). It is undisputed that at the time ROGERS made the statement, NCO'S duty to its subscribers, and by extension ROGERS' duty as a senior analyst at NCO to his employer, was to make independent analyses of the credit of the issuers whose commercial paper NCO was rating. Performance of this duty became of paramount importance to NCO's subscribers after February 4, 1970 when ROGERS and NCO learned of the PENN CENTRAL losses. Failure to make an independent investigation, relying instead on the advice of a seller-subscriber that it was continuing to sell the paper, and rating the paper "prime" on that basis is a serious breach of duty. Indeed, it would possibly subject NCO to civil liability. Munro v. The Bradstreet Company, supra. Clearly, if ROGERS performed his duties in a way which would expose his employer to liability he would be subject to loss of his present employment (and possibly his future employment in the same capacity should his dereliction become known in the investment community) and therefore a declaration or statement to that effect would be against his interest.

A statement is against pecuniary interest when it threatens the loss of employment or reduces the chance for future employment. Gichner v. Antonio Troiano Tile & Marble Co., 410 F. 2d 238 (D.C. Cir. 1969 (Wright, J.)). See also

Koninklijke Luchtvaart Maatschappij N.V. KLM v. Tuller, 292 F. 3d 775, at 784 (D.C. Cir. 1961). It cannot be believed that ROGERS, a man with a reputation of great integrity as an analyst [Tr. 529], would have made a statement "so far contrary" to his "pecuniary interest" as to subject his employer to possible civil liability and to ruin his own career "unless he believed it to be true". Fed. Rules Ev. 804(3). The statement is thus admissible to prove the truth of its contents.

In any event, if it is held that neither of the above exceptions are available, PX-10 was nevertheless properly admitted under Rule 804(5) of the Federal Rules of Evidence which provides that when the declarant is unavailable, a statement which has sufficient circumstantial guarantees of trustworthiness is admissible, if it is material, more probative than other evidence which the proponent reasonably can procure and serves the general purposes of the Federal Rules of Evidence. Fed. Rules Ev. 804(5). With respect to PX-10, all of these criteria have been satisfied.

1. Not only is it unquestioned that VOGEL recorded ROGERS' statement accurately, but independent corroboration of its making is supplied in a separate memorandum of

WILSON. [PX 12]. As to its trustworthiness from the point of view of the character of the declarant, GOLDMAN, SACHS' own witness and the author of the memorandum (VOGEL) testified that ROGERS was one of the "finest men" of his acquaintance and that his integrity was beyond question [Tr. 529-30]. There was no motive for falsification and little likelihood of misstatement. The declarant had a high reputation regarding the matters of which he spoke and the document in which the statement appeared was itself reliable as to the "circumstances attending [its] ... preparation". Accordingly, it has been established that the statement was guaranteed to be trustworthy. See Merriam Co. v. Syndicate Publ. Co., 207 F. 515, 519 (2nd Cir. 1913) (L. Hand, Jr.), wherein the Court noted that the "attitude of the Circuit Court of Appeals for the Second Circuit upon such questions is liberal rather than narrow." [Citation Omitted]

2. The statement, offered to prove that NCO was relying on GOLDMAN, SACHS' statement that it would continue to sell paper, rather than upon its own independent investigation in rating the PENN CENTRAL paper prime, is clearly material to the issue of GOLDMAN, SACHS' non-disclosure of this fact to the FOUNDATION.

3. ROGERS was the senior analyst at NCO and had the responsibility for NCO's rating of PENN CENTRAL commercial paper. [Tr. 528-542]. Since ROGERS died before he could have been deposed [Tr. 529], the FOUNDATION could not have procured his sworn testimony on the matter.

4. The purposes of the Federal Evidence Rules is not only set forth in Rule 102 but the theme of the rules favoring admissibility and granting broad discretion to the trial judge has been documented and commented upon. See, e.g. Rothstein, Understanding the New Federal Rules of Evidence, 1975 Supplement pp. 10-25 (Law Journal Press 1975). Furthermore, this is a non-jury case where rules of evidence fashioned to protect jurors from the influence of unreliable testimony traditionally are relaxed.

For the foregoing reasons, the Court's admission of PX- 10 without limitation was proper.

B. NONDISCLOSURE OF THE MAKING OF ROGERS' STATEMENT

Even if ROGERS' statement is hearsay, the mere making of that statement, as opposed to its truth, was a material fact. The omission to disclose that the statement was made is therefore also material. Thus, LEMAY testified that had he been aware of the making of ROGERS' statement he would not have purchased the PENN CENTRAL commercial paper for the FOUNDATION:

> "Q. As of March 13, 1970 were you aware of the fact that on or about February 5, 1970, National Credit Office had advised* GOLDMAN, SACHS that it would continue the National Credit Office's prime rating PENN CENTRAL commercial paper if GOLDMAN, SACHS continued to sell it?
>
> A. No
>
> * * *
>
> Q. Had you been aware of that fact, Mr. LEMAY, what would you have done differently, if anything?
>
> A. Again withdrawn the name for further investigation by our credit department for lack of quality." [Tr. 39, 40] (Emphasis supplied)

The materiality of GOLDMAN, SACHS' omission to disclose the VOGEL-ROGERS conversation in connection with its representation to LEMAY that the PENN CENTRAL commercial paper was rated prime is established by the foregoing testimony of

*It should be noted that LEMAY was asked if he had been aware that NCO had "advised" GOLDMAN, SACHS that it would continue the paper's prime rating if GOLDMAN, SACHS continued to sell it. He was not asked if he was aware that NCO was in fact continuing its prime rating because GOLDMAN, SACHS was continuing to sell the paper. In this connection, GOLDMAN, SACHS' counsel stated, "I agree it is not an issue in this case as to what NCO's actual opinion was, but merely what they expressed to the world at large." [Tr. 535]

LEMAY. Additional evidence of materiality is established by the fact that during this time NCO was the only agency which rated commercial paper [Tr. 8, 9], investors wanted and relied upon NCO's ratings [VOGEL Dep. 197; HARRE Dep. 50; TOLAN Dep. 20, 21, 41] and GOLDMAN, SACHS' used NCO's prime rating as a marketing tool for selling commercial paper [COLEMAN Dep. 31, 32; VOGEL Dep. 196, 197].

Accordingly, the failure of GOLDMAN, SACHS to disclose that NCO was continuing to rate PENN CENTRAL commercial paper prime because GOLDMAN, SACHS was continuing to sell it or that ROGERS made such a statement to GOLDMAN, SACHS constituted a bare material omission or one which was necessary to make other statements made by GOLDMAN, SACHS not misleading.

2. GOLDMAN SACHS DID NOT DISCLOSE ITS FUTILE EFFORTS TO HAVE PENN CENTRAL INCREASE THE BANKLINE COVERAGE FOR ITS COMMERCIAL PAPER FROM 50% to 100%

From February, 1969, until GOLDMAN, SACHS stopped selling PENN CENTRAL commercial paper in the spring of 1970, it sought without success to have PENN CENTRAL increase the bankline coverage for its commercial paper from 50% (Tr. 582) to 100%.* The history of GOLDMAN, SACHS' futile efforts to have PENN CENTRAL increase the bankline coverage for its commercial paper from 50% to 100% is documented by the following Blue Sheets:

1. PX 21:

"PENN CENTRAL CO. PHILADELPHIA, PA.
February 27, 1969

After consultation with J.H. Rhoades and M.L. Evans, I advised Bill Gerstnecker, VP Corporate, that their plan for the increase by $50MM in c/p outstandings (to $150MM) did not require the Penn Central to increase their lines of credit due to the temporary nature of the program and their access to credit. If they determined subsequently to hold at or near the upper limit, I told Bill we felt they should increase lines by $25-50MM. Ed Taylor, general counsel to the P/C is now in Washington attempting to amend their ICC application accordingly. They will send us a copy of the latter, approved, plus a new borrowing resolution and the new revolving credit agreement.

Pieter A. Fisher

CC: GLLevy, JCWhitehead, JHRhoades, RGWilson, PAHager, LEDrypolcher, RMLynch; JAVogel, MLEvans"

*LEVY testified that the following were the "primary problems" GOLDMAN, SACHS had with PENN CENTRAL: "...we wanted them to get 100 per cent bank-line coverage and we only had 50 per cent and the problem was the paper was not moving very fast." [LEVY Dep. 140]

PIETER FISHER, the corporate finance new businessman assigned to the PENN CENTRAL account, was not called upon by GOLDMAN, SACHS to explain why he recommended that in February, 1969, a non-temporary increase in PENN CENTRAL's outstanding commercial paper should be accompanied by an increase in the railroad's banklines.* This Blue Sheet appears to reflect the first occasion on which GOLDMAN, SACHS was notified that PENN CENTRAL intended to increase its original $100,000,000 of commercial paper outstanding.

2. PX 20, a Blue Sheet by VOGEL dated September 19, 1969, reporting on the September 11, 1969 meeting between PENN CENTRAL and GOLDMAN, SACHS:

> "John O'Herron, Vice President-Finance, called today by appointment and visited with RGWilson, LEDrypolcher and the writer. The purpose of his visit was to outline Penn Central's short-term borrowing needs in the near future and to discuss increasing commercial paper to $200MM from the current $150MM level. John told us that the company has applied to the I.C.C. to extend the $50MM portion of commercial paper presently outstanding which had been previously authorized up to September 30 and to increase the permitted amount of $200MM. He is expecting approval shortly. The company is currently borrowing $250MM out of total of a $300MM revolving credit and has arranged credit lines of $50MM outside of the revolver. It is his intention to use the $50MM outside lines and $50MM of the revolver as backup for the $200MM in commercial paper. RGWilson discussed the nuances of the current commercial paper market, particularly the stronger emphasis on bank line coverage in the minds of investors. He asked if it were possible for Penn Central to get an additional $50MM in lines and John

*GOLDMAN, SACHS cannot explain away this requested increase in banklines by arguing that in times of tight money investors wanted commercial paper with more banklines [e.g. Tr. 325, 386] because VAN CLEAVE and WILSON testified that the "tight money period started" about September, 1969 [Tr. 386, 867, 870]. Similarly WILSON testified that in November and December, 1969, investors were becoming nervous and he "thought that the way to offset some of that nervousness by certain of these investors was to get more banklines . . . ." [Tr. 867]

said it was but he would prefer not to do so. The outside lines presently in force could be used on a demand basis which of course will add to the company's flexibility.

John said that if we were to consider the relationship of $200MM in commercial paper to a total asset structure of some $4 1/2 billion it really is a small amount. He feels that the company has receivables of $240MM which could be used to back commercial paper and has investments in various securities which could be liquidated in an emergency. Furthermore, a $40MM financing being contemplated by the Pennsylvania Company could be increased according to O'Herron. John feels that all of these factors should be considered in lieu of increasing banklines. RGWilson said that we would for the time being not insist on such increase and would report back to him on any market resistance the Penn Central notes received because of the 50% coverage factor." (Emphasis supplied)

This Blue Sheet appears to reflect the first occasion on which GOLDMAN, SACHS was notified that PENN CENTRAL intended to increase its outstanding commercial paper from $150,000,000 to $200,000,000. Again, GOLDMAN, SACHS, upon learning of a proposed increase in the amount of PENN CENTRAL's outstanding commercial paper, requested but did not "for the time being insist" on a commensurate "increase" in supporting banklines.

3. PX 28, a November 10, 1969 Blue Sheet from WILSON with copies to LEVY and FISHER:

"In talking with John O'Herron, Vice President, this morning about how fast we could put out the additional $50MM Penn Central paper, I told him that the recent article in the New york Times financial page quoting their counsel, Mr. Cox, to the effect that Penn Central was having a very rough time with the merger, could be very harmful to the sale of their commercial paper. I advised him that they may want to be thinking about getting another $50MM of standby lines."

4. PX 22, a December 9, 1969 Blue Sheet by VAN CLEAVE, with "cc: RGW LWD PAF JAV RML":

"The purpose of the meeting was to discuss the overall commercial paper and bank borrowing program for the company. The company has a revolving credit of $300MM of which they owe $250MM, $50MM in straight lines of credit of which they are owing zero. Total commercial paper outstanding is $200 MM which gives them 50% line coverage.

* * * *

JAVogel brought up the subject of line coverage pointing out that there are now investors that will not buy c/p unless there is 100% coverage, and that although we do not feel 100% coverage is necessary, questions are being asked in this regard." [Underscoring supplied]

5. PX 11, a February 5, 1970 "CONFIDENTIAL" Blue Sheet by WILSON:

"This morning's press announced that Penn Central Transportation Company had an operating loss of $56MM for the year 1969 and that the railroad was writing off its investment in equipment facilities and terminals being used for long-haul passenger service west of Harrisburg, Pennsylvania and Albany, New York. Penn Central, consolidated, showed a profit of approximately $4MM for 1969. Having talked with GLL last night and JCH this morning, I called John O'Herron, Vice President of Penn Central Transportation.

* * * * * * * * * *

I told John it was unfortunate that we did not have some indication of the magnitude of the total losses for 1969, as we are going to need a story to tell existing holders of Penn Central's paper and new purchasers of paper. I told him it was our judgment that this news will have an adverse effect on their sale of c/p and we may not be able to keep out $200 MM of their notes. I said the most important thing they could do is to get another $100MM in standby lines to back up their c/p and that some of these lines should be swing lines or demand lines. He said he did not think that with the banks as tight as they are, they could get $100MM in standby lines.

* * * * * * * * *

To summarize our position, Penn Central is on notice that we feel the earnings report will have an adverse effect on the sale of their paper and they may not be able to keep out $200MM. We have asked them to set up $100MM in new lines so that they will have 100% line coverage."

6. PX 12, a February 6, 1970 Blue Sheet by WILSON:

"GLL and I had lunch today with Dave Bevan ...; John O'Herron ...; and Bob Loder, Treasurer.

* * * * * * * * * * * *

We then got into a discussion of c/p and we told them that if they didn't get the $100MM more in lines to bring them up to 100% line coverage, we thought their present level of $200MM would run down by $50MM-$100MM."

7. PX 14, a March 23, 1970 Blue Sheet by WILSON:

"I talked at length with John O'Herron, Vice President, today. With some reluctance he told me the first quarter's figures will look terrible. The railroad will show an operating loss which they may or may not offset with profits from the sale of certain assets. He then told me of the $50MM backup lines for c/p $17MM have been converted to demand lines. Regarding their obtaining 100MM of Eurodollar backup lines for c/p, he said he has on his desk Ray Lepley's memorandum. John said he didn't think it was complete enough and was not prepared to take any action at this time. I emphasized how important it is for them to get more lines as some investors are being more selective in their buying of notes and wanted full line coverage.

* * * * * * * * * * * *

I told him that was not my understanding and that, in fact, GS&Co. felt that a $5MM ceiling was appropriate until such time as they obtained 100% line coverage, completed some of these long-term financings, and started to reduce the operating losses."

During this same period of time, GOLDMAN, SACHS encouraged its commercial paper issuers to have 100% bankline coverage [Tr. 783] and most did. The only commercial paper issuers not having 100% bankline coverage during this period, other than PENN CENTRAL, that WILSON could recall were "some of the AT&T subsidiaries . . ." [Tr. 870]. Thus, LEPLEY testified as follows with respect to the December 9, 1969 meeting between GOLDMAN, SACHS and PENN CENTRAL [PX 22]:

"Q. Did he [VAN CLEAVE] say that it was customary for companies to have either eighty percent or one hundred percent line coverage?

A. I don't remember eighty percent, but I remember him saying it was customary for many of the customers to have one hundred percent back-up, and as I remember, I pursued that a little further with him and he said on some of them, perhaps they would have something less than one hundred percent, but the majority of their customers, he indicated had one hundred percent." [LEPLEY Dep. 46]

"Q. Do you recall anything that you said at the meeting of December 9?

A. I inquired a little bit more deeply on the number of customers that they might have that had one hundred percent back-up.

Q. Can you recall why you did so?

A. I wanted to make sure when we got to the office, that we could report that indeed we were more or less, sticking out like a sore thumb among Goldman Sachs customers not having a high percentage of back-up.

Q. Did you reach just that conclusion after the meeting of December 9?

A. I would say I was pretty well convinced." [LEPLEY Dep. 49, 50]

During this period of time, as the following Blue Sheets reveal, "more and more" [Tr. 514] of GOLDMAN, SACHS' sophisticated and professional investors* wanted only commercial paper that had 100% bankline coverage:

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*VAN CLEAVE testified that commercial paper "is strictly a sophisticated investor's market . . . ." [Tr. 237, 361]. LEVY testified that approximately 90% of Goldman, Sachs' customers for commercial paper were "professional investors." [Tr. 780]

1. At the September 11, 1969 meeting between PENN CENTRAL and GOLDMAN, SACHS,

> "RGWilson discussed the nuances of the current commercial paper market, particularly the stronger emphasis on bankline coverage in the minds of investors." [PX 20]

WILSON testified that at this meeting he told O'HERRON:

> "I told John that the market at that time was becoming tighter. 'Tighter' to me means interest rates were continuing to rise, that investors, some investors were looking for fuller line coverage, close to 100 percent. Even for some of the very largest issuers of paper." [WILSON Dep. 50]

2. At the december 9, 1969 meeting with PENN CENTRAL,

> "JAVogel brought up the subject of line coverage pointing out that there are now investors that will not buy c/p unless there is 100% coverage...." [PX 22]

LEPLEY testified that at this meeting he was advised by GOLDMAN, SACHS that it wanted PENN CENTRAL to have 100% bankline coverage to "facilitate the sale of our commercial paper" and because "investors in general looked for commercial paper that had a one hundred percent back-up." [LEPLEY Dep. 26]

3. With respect to the February 6, 1970 meeting [PX 12], BEVAN testified:

"Q. Do you have any recollection of having discussed with any representative of Goldman Sachs, whether it was on February 6 or sometime in early 1970, the possibility of increasing the bank line coverage .....

A. Yes.

Q. ---- on the commercial paper?

A. Yes. I can't tell you whether it came to me directly from them or whether by way of John O'Herron..

But they thought as a precaution, being conservative, that we could -- and they also said that they had some buyers who had a rule that they would only do -- buy any of your commercial paper where there was a hundred per cent coverage, so they thought that would improve our market and that this was the conservative thing to do." [BEVAN Dep. 46, 47]

4. In a telephone conversation on March 23, 1970, with O'HERRON, WILSON "emphasized how important it is for them to get more lines as some investors were being more selective in their buying of notes and wanted full line coverage." [PX 14].

In addition to the foregoing statements that investors were concerned with and desired greater bankline coverage than was possessed by PENN CENTRAL, such concern was admitted by the following individuals: LEVY, WILSON, VOGEL, LEPLEY, BEVAN, ANCZARKI, HANSELL, HARRE, STUTT, TOLAN, and BRENKERT.*

There can be no doubt that GOLDMAN, SACHS recognized that 100% bankline coverage was important and significant to

*Respectively [LEVY Dep. 186, 190] [WILSON Dep. 50, 121]; [VOGEL Dep. 130, 152]; [LEPLEY Dep. 26]; [BEVAN Dep. 46, 47]; [ANCZARKI Dep. 20]; [HANSELL Dep. 7, 23]; [HARRE Dep. 50]; [STUTT Dep. 37]; [TOLAN Dep. 31]; [BRENKERT Dep. 9].

commercial paper investors, including GOLDMAN, SACHS. Thus, LEVY and WILSON told BEVAN, O'HERRON and LODER of PENN CENTRAL at their February 6, 1970 luncheon, ". . . that if they didn't get the $100MM more in lines to bring them up to 100% line coverage, we thought their present level of $200MM would run down by $50MM-100MM" [PX 12]. In other words, GOLDMAN, SACHS believed that the existence of 100% bankline coverage would influence the investment decisions of commercial paper buyers to the extent of PENN CENTRAL commercial paper purchases in the range of $50,000,000 to $100,000,000. Similarly, on March 23, 1970 WILSON told O'HERRON the $5,000,000 inventory limitation would not be removed "until", among other things, "they obtained 100% line coverage . . . ." [PX 14].

The foregoing uncontroverted evidence that many of GOLDMAN, SACHS' sophisticated and professional investors wanted only commercial paper that had 100% bankline coverage, that most of GOLDMAN, SACHS' issuers had 100% bankline coverage and that in early February, 1970 GOLDMAN, SACHS believed that PENN CENTRAL's failure to increase its bankline coverage from 50% to 100% would result in a run-off estimated to range from 25% to 50% of their outstanding paper, clearly establishes the materiality of the banklines omission by GOLDMAN, SACHS.

The materiality of the futile efforts of GOLDMAN, SACHS to have PENN CENTRAL obtain additional banklines, which was unknown to the FOUNDATION, is further evidenced by the testimony of LeMAY [Tr. 32]:

"Q. As of March 13, 1970, had you been aware of the fact that since fall of 1969, Goldman, Sachs had been requesting Penn Central to increase its banklines from 50 per cent to 100 per cent and that Penn Central had not done this, what would you have done, if anything

Mr. GRAHAM: Objection.

* * *

A. We would not have shown the paper.

The COURT: On what basis?

The WITNESS: The basic reasons of questions as to quality."

Finally, disclosure of GOLDMAN, SACHS' requests for, and PENN CENTRAL's inability to obtain, increased coverage was necessary to make GOLDMAN, SACHS' representation that PENN CENTRAL was creditworthy and that an adequate credit investigation had been conducted not misleading because the inability to obtain banklines is an indication of a lack of creditworthiness (see the Point concerning GOLDMAN, SACHS' representation that PENN CENTRAL was creditworthy).

GOLDMAN, SACHS contends that: (1) banklines have nothing to do with the safety of commercial paper and (2) when PENN CENTRAL said at the February 6, 1970 luncheon that "they did not feel they could get $100MM in banklines at this time" [PX 12], GOLDMAN, SACHS did not believe them [Tr. 894] because WILSON felt they wanted to avoid the costs involved in securing an additional $100,000,000 in banklines. These contentions, even if true, are irrelevant to the issue of materiality, (although contention "2" is clearly relevant to the issue of creditworthiness and thus is discussed in

greater detail at Point II-A, supra) because the uncontroverted evidence reveals that many professional and sophisticated commercial paper investors, in any event, wanted only commercial paper with 100% banklines. In addition, the UNION BANK would not have shown the PENN CENTRAL commercial paper to the FOUNDATION on March 13, 1970 (had it been aware of this omission) whether or not 100% bankline coverage has a bearing on the "safety" of such paper* [Tr. 32].

In addition to being irrelevant, the contention that bankline coverage for commercial paper does not provide any safety to commercial paper holders is rebutted by the following evidence:

1. Of the $100,000,000 in banklines supporting PENN CENTRAL's commercial paper, $96,000,000 was actually used in the spring of 1970 by PENN CENTRAL [LEPLEY Dep. 32; SULLIVAN FSB Tr. 878, 879].

*Of course, there is no evidence to indicate that GOLDMAN, SACHS ever told any one of its increasingly large number of investors who wanted commercial paper with 100% banklines, that banklines have nothing to do with safety or that they were being lazy or arbitrary in seeking paper with 100% bankline coverage. Instead, GOLDMAN, SACHS listened to its investors' demands for commercial paper with 100% bankline coverage and told PENN CENTRAL to increase its banklines so that it could sell more paper to these investors. Thus WILSON testified:

> ". . . rather than lose accounts that were buying Penn Central I wanted to make sure we held on to all the ones that we had and maybe even add more to it. So that was my reasoning behind recommending to them that they get more banklines." [Tr. 867]

2. PENN CENTRAL regarded banklines as being the equivalent of assets which could be liquidated to pay commercial paper indebtedness. In its application to the ICC to increase the amount of outstanding commercial paper to $200,000,000, dated September 11, 1969 [PX 68, at p. 9], PENN CENTRAL stated:

> "Assuming the issuance of the commercial paper described in this Application, Applicant will have outstanding $200,000,000 of commercial paper backed up by loan commitments of banks in the amount of $100,000,000. Such loan commitments provide reasonable assurance that Applicant will be able to meet such of its commercial paper maturities as it may not be able to refund by new issues of commercial paper or by issuance of other securities or pay out of cash in its treasury."

On October 1, 1969 PENN CENTRAL advised the Interstate Commerce Commission that:

> "Bank lines of credit for $100 million have been exclusively committed to refund maturing commercial paper notes of Penn Central Transportation Company if at any time market conditions prevent the sale of commercial paper notes to meet maturities of such notes. In addition, Penn Central Transportation Company and its subsidiaries have assets which can be liquidated to cover maturing commercial paper notes. [PX 67]

3. PENN CENTRAL, in its financial statements carried the amount of its commercial paper which was backed by banklines as long term debt due after one year [PX 39, p. 2].

3. GOLDMAN, SACHS DID NOT DISCLOSE ITS $10,000,000 REDUCTION IN PENN CENTRAL COMMERCIAL PAPER INVENTORY AND ITS SUBSEQUENT $5,000,000 INVENTORY LIMIT

On February 4, 1970, PENN CENTRAL announced its preliminary earnings for 1969, including its fourth quarter losses. In a telephone conversation on February 5, 1970, WILSON asked O'HERRON to have PENN CENTRAL repurchase $10,000,000 of the $15,000,000 in PENN CENTRAL commercial paper which GOLDMAN, SACHS had in inventory and O'HERRON agreed to do so on February 9, 1970 [PX-11]. During the meeting between PENN CENTRAL and GOLDMAN, SACHS on February 6, 1970, PENN CENTRAL was advised that after the repurchase of the $10,000,000 of inventory, GOLDMAN, SACHS would impose a $5,000,000 inventory limit or ceiling [PX-12] "until such time as they [PENN CENTRAL] obtained 100% line coverage, completed some of these long-term financings, and started to reduce operating losses" [PX-14]. An inventory limit had never been placed on an individual industrial issuer such as PENN CENTRAL by GOLDMAN, SACHS prior to imposition of the same on PENN CENTRAL [Tr. 819; VAN CLEAVE Dep.185-186; LYNCH Dep. 41].* On February 9, 1970, PENN CENTRAL repurchased $10,000,000 of its commercial paper from the inventory of GOLDMAN, SACHS by utilizing its existing banklines of credit [PX-12].

*On or about December 1, 1969, WILSON sent a memorandum (DX-BM) to GEORGE E. DOTY (Administrative Partner at GOLDMAN, SACHS) suggesting inventory limitations to be placed on certain finance issuers. However, in contrast to PENN CENTRAL, each of these issuers was a finance company [Tr. 725] and PENN CENTRAL was not listed in the memorandum.

In connection with the purchase of PENN CENTRAL commercial paper by the FOUNDATION on March 13, 1970, GOLDMAN, SACHS did not disclose the fact of the inventory reduction or limitation to the FOUNDATION. Thus, LeMAY testified [Tr. 35]:

> "Q. As of March 13, 1970, were you aware of the fact that Goldman, Sachs had on February 9, 1970, sold $10,000,000 of its $15,000,000 inventory of commercial paper of Penn Central back to Penn Central?
>
> A. No.
>
> Q. Were you aware of the fact as of March 13, 1970, that on or about February 5, 1970, Goldman, Sachs had for the first time imposed an inventory limit of $5,000,000 on Penn Central's commercial paper?
>
> A. No.

The materiality of such omissions is similarly evidenced by the testimony of LeMAY [Tr. 35]:

> "Q. Had you been aware of these facts on March 13, 1970, what would you have done differently, if anything.
>
> A. Again, we would not have shown the paper [to the FOUNDATION]. We would have perhaps asked questions and not shown it to our customers.
>
> Q. Why wouldn't you have shown it?
>
> A. It would be a question of quality and we would have to check with further investigation, which I would have turned over to our credit department to do so."

Although this testimony alone indicates the importance of

the inventory omissions, the materiality of the same can not be doubted, especially in the context of the events which transpired.

To recapitulate, at the end of 1969, PENN CENTRAL was in poor financial condition and had not obtained bankline coverage for 50% of its outstanding commercial paper.* The extent of PENN CENTRAL'S financial problems, however, was not fully appreciated until the February 4, 1970 announcement of PENN CENTRAL'S 1969 losses. Within two days thereafter, GOLDMAN, SACHS eliminated $10,000,000 of risk from its inventory and insured that a risk in excess of $5,000,000 would not be borne in the future.** In the context of such facts, it must be concluded that a reasonable investor would have considered the inventory omissions important.***

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*Although GOLDMAN, SACHS was capable of maintaining a high level of outstandings for PENN CENTRAL, when it had 50% bankline coverage, it is submitted, as Judge Metzner indicated (p. 19-20), that in the absence of the misrepresentations and omissions discussed herein, the marketability of the PENN CENTRAL commercial paper would have been drastically reduced.

**Not only did GOLDMAN, SACHS impose a $5,000,000 inventory limit on PENN CENTRAL commercial paper but, it was also understood that PENN CENTRAL'S "backup lines will be made available to cover runoffs for maturities in excess of what they don't sell plus our $5MM position." [PX-12] (Emphasis Supplied).

***Thus, Judge Metzner concluded in Franklin v. Levy that, "if investors knew that GOLDMAN, SACHS had arranged for buybacks by PENN CENTRAL of $10 million of its inventory ... there is no doubt in my mind that there would be no chance of ever selling this paper as roll overs for maturing papers. The run down of outstanding paper would have been dramatic, and PENN CENTRAL would have been beating a trail to the courthouse steps three months sooner than it did." (p. 19-20)

The significance of the inventory reduction and limitation is vividly demonstrated by its comparison with GOLDMAN, SACHS' reduction of PENN CENTRAL commercial paper inventory in December, 1969. On December 24, 1969, PENN CENTRAL repurchased $16,170,000 of its commercial paper from GOLDMAN, SACHS' inventory, thereby reducing the PENN CENTRAL commercial paper inventory of GOLDMAN, SACHS to $50,000 (DX-CU). The December repurchase was funded by PENN CENTRAL with proceeds from the sale of a $50,000,000 debenture by PENN CO., a subsidiary of PENN CENTRAL [Tr. 308-309] and was made at a time when the PENN CENTRAL commercial paper was selling well [Tr. 395-396, 438]. In connection with the December repurchase, no earnings announcement was made by PENN CENTRAL, no meeting was held between GOLDMAN, SACHS and PENN CENTRAL and, GOLDMAN, SACHS did not impose an inventory limitation. In contrast, the $10,000,000 inventory reduction on February 9, 1970 (a) was funded by PENN CENTRAL'S utilization of its "precious"* banklines of credit [PX 12; Tr. 307-309, 407] (b) was made at a time when GOLDMAN, SACHS anticipated a run-off of the PENN CENTRAL commercial paper [PX-11, 12], and (c) was a result of the February 4, 1970 earnings announcement by PENN CENTRAL, the telephone conversation between WILSON and O'HERRON on February 5, 1970 [PX-11] and the meeting between GOLDMAN, SACHS and PENN CENTRAL on February 6, 1970 [PX-12].

*Franklin v. Levy, p. 19.

Furthermore, in connection with the reduction, GOLDMAN, SACHS imposed a $5,000,000 inventory limitation on PENN CENTRAL commercial paper.

In addition to the distinctions between the December and February repurchases, it is clear that GOLDMAN, SACHS considered the inventory omissions material and significant. Th .., when WILSON proposed to have PENN CENTRAL repurchase $10,000,000 of GOLDMAN, SACHS' inventory, the response of O'HERRON was:

> "He said he didn't think he wanted to do that [repurchase] today [February 5], as the New York banks he is going to see this afternoon to set up the additional $50 MM 5-month lines are the same ones he would have to contact today and he didn't feel this was very good strategy. I concurred with his reasoning." [PX-11] (Emphasis Supplied).

The imprudence of indicating to the banks (from whom bank-lines were allegedly to be sought) that on the day after its 1969 earnings were announced PENN CENTRAL'S exclusive commercial paper dealer was substantially decreasing its PENN CENTRAL inventory is obvious. It would indicate GOLDMAN, SACHS' lack of faith in PENN CENTRAL'S ability to pay its debts when they matured* or PENN CENTRAL'S lack of creditworthiness. Accordingly, the WILSON-O'HERRON strategy was to not alert the banks of GOLDMAN, SACHS' concern for PENN CENTRAL'S financial

*Thus, Judge Metzner concluded "It is an inescapable conclusion that starting with February 4, GOLDMAN, SACHS did not have faith in this [PENN CENTRAL'S] paper any more and was lightening its load and reducing its exposure." (p. 19).

condition and to have PENN CENTRAL repurchase its commercial paper after the banks had given (or refused as was the case) PENN CENTRAL additional banklines. Therefore, for all intents and purposes, GOLDMAN, SACHS has admitted the significance or materiality of the inventory omissions, if only by anticipating the reaction of the banks to a disclosure of the omitted facts. Likewise, VOGEL did not disclose GOLDMAN, SACHS' inventory reduction to ROGERS of NCO during their February 5, 1970 telephone conversation, presumably for the same reasons.

In response to the foregoing, GOLDMAN, SACHS maintains that the reduction and limitation on inventory were unrelated to the financial condition of PENN CENTRAL, but, rather, were a function of legitimate business reasons. The alleged reasons were that (1) a "negative carry loss" (as opposed to an expense) was occurring with respect to the PENN CENTRAL commercial paper* in GOLDMAN, SACHS' inventory, (2) a "loss" was resulting from the necessity of marking up** the PENN CENTRAL commercial paper inventoried by GOLDMAN, SACHS***, and (3) GOLDMAN, SACHS anticipated a decreased investor demand for PENN CENTRAL commercial paper as a result

*That is, the cost to finance PENN CENTRAL'S inventory exceeded the spread which GOLDMAN, SACHS realized on the sale of PENN CENTRAL'S commercial paper.

**A markup of the rate on the commercial paper resulted in a decrease of the spread or profit GOLDMAN, SACHS realized from a sale.

***It should be noted, however, that regardless of these "losses", the commercial paper department of GOLDMAN, SACHS was profitable in 1968, 1969 and 1970 [PX-75].

of the February 4, 1970 earnings announcement, thereby eliminating the necessity for having a large inventory.

It is clear, however, that GOLDMAN, SACHS' primary motivation for reducing and limiting the PENN CENTRAL inventory was to decrease its risk and that the alleged business reasons were, at best, only incidental considerations. Thus, notwithstanding the fact that negative carry and markup "losses" were occurring with respect to other issuers, GOLDMAN, SACHS only reduced and limited the inventory of PENN CENTRAL. In addition, although GOLDMAN, SACHS was aware that these "losses" were occuring prior to the beginning of 1970 with respect to issuers which had large inventory positions, it took no steps to counteract the situation. It was only when PENN CENTRAL announced its 1969 earnings on February 4, 1970 that the inventory of PENN CENTRAL, alone, was reduced and limited.* Indeed, the formal recommendations to reduce and limit inventory which were made by WILSON and VAN CLEAVE, inter alia, and were contained in the "Blue Book Report" dated March, 1970 [PX-75]** were never adopted by the Management Committee of GOLDMAN, SACHS to which it was submitted [Tr. 719-720]. To the contrary, the recommendations received adverse comments from JOHN C. WHITEHEAD, the

*Moreover, such reduction was effectuated before any run-off of the PENN CENTRAL commercial paper would have occurred and, in fact, no such run-off resulted from the February 4, 1970 announcement.

**The "Blue Book Report" or the "confidential" "Report On The Commercial Paper Department For the Management Committee And The Partnership" was a study of the profitability of the Commercial Paper department which attributed decreased profits to the alleged "business reasons", supra.

partner on the Management Committee who had responsibility for GOLDMAN, SACHS' new business department [PX-76]. Finally, as indicated in WILSON'S "Blue Sheet" of March 23, 1970 [PX-14], the limitation on inventory would only continue until PENN CENTRAL obtained long term financing, 100% bankline coverage and decreased its operating losses. Therefore, the inventory reduction and limitation could not have been the result of a change in policy by GOLDMAN, SACHS because the same were only to be imposed until such time as PENN CENTRAL evidenced that it was financially stable by obtaining financing, bankline coverage and decreasing its losses. A true policy decision by GOLDMAN, SACHS based on the aforementioned business reasons would not have been implemented on a temporary basis subject to PENN CENTRAL'S financial condition. Consequently, it is not possible to attribute the inventory reduction and limitation to business reasons.* Although such factors may have been extant, the true impetus for GOLDMAN, SACHS' action with respect to the PENN CENTRAL inventory was GOLDMAN, SACHS' knowledge of the precarious financial condition or decline of PENN CENTRAL.

Finally, in addition to being bare omissions, for the reasons set forth above, because the inventory omissions

*Thus, notwithstanding the business "explanation" offered by GOLDMAN, SACHS, Judge Metzner in Franklin v. Levy concluded that on February 4, 1970, GOLDMAN, SACHS had lost "faith" in PENN CENTRAL'S commercial paper.

were related to the financial condition of PENN CENTRAL and GOLDMAN, SACHS' assessment of the same, it is clear that the representations made by GOLDMAN, SACHS with respect to the creditworthiness of PENN CENTRAL and its credit investigation were misleading by virtue of the inventory omissions. Consequently, the inventory omissions were required to make such representations not misleading.

4. GOLDMAN, SACHS DID NOT DISCLOSE THE REMOVAL BY BROWN BROS. HARRIMAN & CO. OF PENN CENTRAL COMMERCIAL PAPER FROM ITS LIST OF APPROVED ISSUERS

On February 4, 1970, PENN CENTRAL announced that it lost $56,000,000 in 1969 of which $16,000,000 was attributable to losses in the fourth quarter. On February 5, 1970, BROWN BROS. removed PENN CENTRAL from its approved list of commercial paper issuers. BROWN BROS. was, and is, a commercial bank of excellent reputation having substantial experience in connection with railroads [Tr. 829-830, WILSON Dep. 640, WEINBERG Dep. 128]. BROWN BROS. had a long standing banking relationship with PENN CENTRAL and had extended PENN CENTRAL a $2,000,000 line of credit in August, 1968 with respect to its commercial paper [PX-34, DX-BY]. In addition, at the time of the PENN CENTRAL announcement, BROWN BROS. held approximately $30,000,000 in PENN CENTRAL commercial paper or 15% of PENN CENTRAL'S $200,000,000 outstandings [PX-12].

When the FOUNDATION purchased the PENN CENTRAL commercial paper it was not aware that BROWN BROS. had removed PENN CENTRAL from its approved list. Thus, LEMAY testified [Tr. 30-32]:

> "Q. As of March 13, 1970, were you aware of the fact that Brown Bros. Harriman Company had removed Penn Central commercial paper from its approved list of commercial paper issuers?

A. No, I was not.

Q. As of March 13, 1970, were you aware of the fact that prior to that date Brown Bros. Harriman Company had on occasion purchased up to 15 per cent of the amount of outstanding Penn Central commercial paper?

A. No.

Q. Had you been aware of these facts, would you have done anything differently?

A. I believe I would.

MR. GRAHAM: I would register my objection for the record.

THE COURT: I am going to allow the answer. ....

A. I don't believe it would show a name. If there was a question we do not show the name as far as our operation was concerned. There are too many other papers available and we would not have shown Penn Central.

Q. You say you would not have shown the name, what do you mean by that?

A. Not shown it to the customer, disregarded it as not available.

Q. In this particular instance you would not have told Mr. Fitzpatrick that Penn Central commercial paper was available?

A. No.

Q. Is that what you mean?

A. Yes, sir."

Conversely, that GOLDMAN, SACHS had knowledge of the BROWN BROS. action can not be disputed as is evidenced by WILSON'S "Blue Sheets" of February 6, 1970 and February 12, 1970 [PX-12]:

> "....I told him [O'HERRON] about a large New York firm that has bought as much as 15% of their outstandings and which only yesterday temporarily removed their [PENN CENTRAL'S] name from its approved list."

> "....I told JOHN [O'HERRON] that the large investor who had temporarily taken their [PENN CENTRAL'S] name off their approved list did not wish to meet with him to review the 1969 figures as they felt it would be awkward. JOHN O'HERRON guessed that the account we were referring to was BROWN BROTHERS and he has agreed not to make any out-of-the ordinary reviews with them so as not to jeopardize our relationship with BROWN BROTHERS."

As indicated by the above-cited testimony, the omission with respect to BROWN BROS. would have affected LeMAY'S decision to "show" PENN CENTRAL'S commercial paper to the FOUNDATION. The omitted fact was therefore material. Regardless of this testimony, however, it is submitted that any reasonable investor would deem it important that an investment banker with expertise in railroads who owned $30,000,000 of PENN CENTRAL commercial paper had temporarily decided to discontinue purchasing the same.* Moreover, the importance of such a fact would not be diminished by the fact that BROWN BROS. had extended a $2,000,000 line of credit to PENN CENTRAL and that it ultimately honored

*Thus, in Franklin v. Levy, Judge Metzner concluded that, "if investors knew that Goldman Sachs had arranged for buy-backs by Penn Central of $10 million of its inventory, and that Brown Brothers Harriman had stopped buying at all, there is no doubt in my mind that there would be no chance of selling this paper as roll overs for maturing paper. The "run down" of outstanding paper would have been dramatic, and Penn Central would have been beating a trail to the courthouse steps three months sooner than it did." (pp. 19-20).

the line in the spring of 1970. There is no evidence that the line of credit extended by BORWN BROS. was not a confirmed line in which case it could not have been withdrawn by BROWN BROS. In any event, by its action, BROWN BROS., in effect, insured that its losses would be limited to $2,000,000 as opposed to $30,000,000 if PENN CENTRAL failed. Consequently, no significance should be attached to the fact that BROWN BROS. ultimately honored the line of credit which it gave to PENN CENTRAL, especially in light of the facts with respect to which it presumably had no knowledge.

Finally, it is clear that the fact that BROWN BROS. removed PENN CENTRAL from its approved list should have been disclosed to make the statements made by GOLDMAN, SACHS not misleading. If PENN CENTRAL had been creditworthy, there would have been no reason for BROWN BROS. to remove PENN CENTRAL from its approved list. Disclosure of the fact that BROWN BROS., a holder of PENN CENTRAL commercial paper and an investment banker with an acknowledged expertise in railroads, felt that PENN CENTRAL was not creditworthy was therefore certainly required to make such representations not misleading.

5. GOLDMAN, SACHS DID NOT DISCLOSE PENN CENTRAL'S TIGHT CASH POSITION, ITS LACK OF WORKING CAPITAL AND INCREASING LOSSES

During the period from September, 1969 through the date of the purchase of PENN CENTRAL commercial paper by the FOUNDATION, PENN CENTRAL'S financial condition was poor and was getting progressively worse. [HOFFMAN Dep. 26; O'HERRON Dep. (May)* 85-90]. Its cash position was tight [O'HERRON Dep. (May) 85-90; O'HERRON Dep. (April) 51; BEVAN Dep. 148; EVANS' Dep. 58-59, 62-71], it had a deficit working capital position [HOFFMAN Dep. 38; EVANS' Dep. 58-59, 62-71; O'HERRON DEP. (May) 85-90); O'HERRON Dep. (April) 43-45] and its losses were increasing [HOFFMAN Dep. 26; O'HERRON Dep. (April) 43-45, 76-77].

At the September 19, 1969 meeting between GOLDMAN, SACHS and PENN CENTRAL, O'HERRON advised GOLDMAN, SACHS that:

> "...[PENN CENTRAL] will be in a very tight cash position in the first quarter of 1970 and asked if we [GOLDMAN, SACHS] could put out as much paper as possible in April or longer". [PX-20]

On October 22, 1969, O'HERRON called WILSON and said that PENN CENTRAL would:

> "...show a small loss in the 3rd quarter [of 1969], but anticipate[d] the 4th quarter will be 'in the black' with a good improvement." [PX-33]

*With respect to O'HERRON Deposition references, May and April refer to the May 8, 1973 and April 26, 1973 depositions.

On February 4, 1970, PENN CENTRAL announced that its losses for the entire year of 1969 were $56,000,000. Contrary to the production of O'HERRON, the 4th quarter of 1969 was in the "red" with a $16,000,000 loss. As a result of the PENN CENTRAL announcement, WILSON telephoned O'HERRON on February 5, 1970. In response to WILSON'S inquiries regarding the "cash picture" of PENN CENTRAL for the first six months of 1970, O'HERRON said:

> "...it is very tight ... [PENN CENTRAL] will probably need about $200MM to meet their requirements this year." [PX-11]

Thereafter, at the luncheon meeting on February 6, 1970, BEVAN told GOLDMAN, SACHS that PENN CENTRAL estimated a loss of $56,000,000 for 1970 and that therefore, the cash requirements of PENN CENTRAL for 1970 were $226,000,000 [PX-12], an increase of $25,000,000 over the prior day's estimate.

In connection with the purchase of the PENN CENTRAL commercial paper, none of the foregoing facts were disclosed by GOLDMAN, SACHS to the FOUNDATION as indicated by the following testimony of LeMAY [Tr. 35-38]:

> "Q. As of March 13, 1970, were you aware of the fact that in the fall of 1969 Penn Central had advised Goldman, Sachs that it believed its fourth quarter operations would be in the black and that, in fact, Penn Central's fourth quarter railroad operations resulted in a $16,000,000 loss?
>
> A. No.

Q. Had you been aware of that fact on March 13, 1970, what would you have done, if anything?

A. Same reactions, withhold the name until further investigation.

Q. Why is that?

A. There would be reasons to question the quality.

* * *

Q. Mr. LeMAY, as of March 13, 1970, were you aware of that fact that in September of 1969 Penn Central had advised Goldman, Sachs that it would be in a very tight cash position for the first quarter of 1970?

A. No.

Q. And were you aware that at about the same time Penn Central had also told or asked Goldman, Sachs to sell as much of its commercial paper as possible with maturity dates into April, 1970, or longer?

A. No.

Q. Had you been aware of these facts on March 13, 1970, what would you have done differently, if anything?

A. We would have withdrawn the name until further investigation by our credit department.

Q. Why is that?

A. It's the policy for us not to show names until we know that they are okay.

THE COURT: Now that I understand Mr. LeMay's policy in that his department in the bank were simply to accept anything perfect, it's perfectly clear that if he heard of something that was not perfect he would have turned it over to another department for investigation.

Q. As of March 13, 1970, were you aware that on or about February 6, 1970, Penn Central had advised Goldman, Sachs that it was budgeting for a $56,000,000 loss in 1970?

A. No, sir.

Q. Were you aware of the fact that at the same time it had also told Goldman, Sachs that it would have to raise approximately $200,000,000 for its cash needs in 1970?

A. No.

Q. Had you been aware of these facts on March 13, 1970, what would you have done differently, if anything?

A. The same reaction, withdrawn the name for further investigation.

Q. Again why is that?

A. The reason as to questioned quality."

Consequently the above facts were not disclosed to the FOUNDATION. In addition, because of the significance of such facts, the omissions were material to the FOUNDATION. The materiality of the omitted facts is further evidenced by:

1. The concern of investors with respect to the financial condition of PENN CENTRAL. Thus, the following individuals testified that investors or themselves were concerned with an issuer's earnings, its working capital position and its cash position: HARRE Dep. 49-54, 127; TRIPI Dep. 87; WEINBERG Dep. 115, 116, 117, 126, 129; BRENKERT Dep. 9, 22; HANSELL Dep. 25;

2. The fact that WILSON believed that the February 4, 1970 earnings announcement would result in a "run off" of PENN CENTRAL'S commercial paper [PX-11];

3. The fact that ROGERS of NCO called VOGEL on February 5, 1970 "to express concern over the sharply reduced earnings" of PENN CENTRAL [PX-10];

4. The fact that the inventory reduction and limitation imposed by GOLDMAN, SACHS on PENN CENTRAL would continue until PENN CENTRAL reduced its operating losses [PX-14]; and

5. The fact that WILSON instructed the GOLDMAN, SACHS commercial paper salesmen to inform investors of PENN CENTRAL'S first quarter, 1970 earnings, which were contained in the April 22, 1970 Green Sheet [PX-22] [Tr. 912].

Although the FOUNDATION may have generally known that the financial condition of PENN CENTRAL was not good as a result of articles published in the newspapers, the specific facts that the fourth quarter prediction of O'HERRON was incorrect, that the cash position of PENN CENTRAL in 1970 was very tight, and that a $56,000,000 loss (equivalent to that in 1969) was being projected for 1970, could not have been known. In contrast, such facts were clearly within the knowledge of GOLDMAN, SACHS. Finally, the foregoing omissions were related to the representations made by GOLDMAN, SACHS that PENN CENTRAL was creditworthy. Both of these statements related to the financial condition of PENN CENTRAL and therefore material information with respect to such condition, a fortiori should have been disclosed in order to make such statements not misleading.

6. GOLDMAN, SACHS DID NOT DISCLOSE THAT PENN CENTRAL WAS USING THE PROCEEDS FROM ITS SALE OF COMMERCIAL PAPER FOR NON-CURRENT TRANSACTIONS AND THE ICC'S CONCERN OVER THIS PRACTICE

GOLDMAN, SACHS did not disclose that PENN CENTRAL was using the proceeds from the sale of its commercial paper for non-current transactions and that the ICC was concerned about such use. PENN CENTRAL'S use of proceeds from the sale of its commercial paper for non-current transactions and GOLDMAN, SACHS' awareness of such use is demonstrated by the following evidence:

1. PX 68, a public document, is PENN CENTRAL'S September 11, 1969 application to the ICC* for authority to increase the amount of outstanding Commercial Paper from $150,000,000 to $200,000,000. Page 6 of PX-68 states:

> "The proceeds of sale of the commercial paper notes will be used to reimburse the Treasury of Applicant in part for past capital expenditures and matured debt obligation and to replenish its cash."

2. The ICC'S decision [PX-64] approving PENN CENTRAL's September 11, 1969 application was mailed by PENN CENTRAL [PX-66] to WILSON, who read it [WILSON Dep. 522, 523]. It

* WILSON testified that GOLDMAN, SACHS attempted "to keep ourselves informed as to what the Railroad's applications were for, the timing of them, whether to get ICC approval to issue commercial paper, in that they were required before we could go to a higher level." [WILSON Dep. 511]

states, in pertinent part:

> "The exhaustion of short-term credit to refinance maturing long-term debt or to finance long-term capital expenditures could expose a carrier to a serious crisis in the event of an economic squeeze, at which time a carrier may require short-term fanancing for traditional use. We are, therefore, concerned about the use of short-term financing for long-term purposes and feel that where necessary it should be resorted to cautiously." (Emphasis supplied) [PX -64, at p. 4].

3. PX 70, a letter dated May 8, 1969 from PENN CENTRAL to the ICC, is a public document which states:

> "This type of financing (short-term notes] by PENN CENTRAL Company has become necessary because it does not have at the present time a major financing vehicle to reimburse its treasury for past capital expenditures and to pay for future capital expenditures."

4. MICHAEL EVANS, GOLDMAN, SACHS' credit analyst who reviewed PENN CENTRAL'S 1968 Annual Report, "noted" in his written report "that the company carries $50,000 M of c/p as long-term debt due after one year. Management has stated that since PENN CENTRAL has $50,000M in banklines to cover the c/p issued they can carry it long-term." [PX 39, at p. 2].

GOLDMAN, SACHS' failure to disclose that the railroad was using commercial paper sale proceeds for non-

current transactions* is a material omission as evidenced by the testimony of LEMAY that he would not have shown the paper to the FOUNDATION had he been aware of this non-disclosure [Tr. 38, 39].

LEMAY testified that commercial paper "is sold for short-term purposes only" and that he purchased the PENN CENTRAL paper pursuant to that "assumption" [Tr. 39]. Similarly, GOLDMAN, SACHS' witnesses testified as to their understanding that the proceeds of commercial paper sales were to be used for current transactions pursuant to §3(a)(3) of the '33 Act [Tr. 365, 843]. This understanding included transportation companies in general** and PENN CENTRAL in particular. Thus, VAN CLEAVE testified that he

*At trial [Tr. 850,851] and during his deposition WILSON appeared to contend that so long as PENN CENTRAL'S accounts receivable exceeded the amount of its outstanding commercial paper "one could argue, that those proceeds were, in fact, used to finance those receivables." [WILSON Dep. 726]. Apart from its lack of logic there is no factual support for this contention in the record. At the time of its September 11, 1969 application to the ICC to increase its outstanding commercial paper from $150,000,000 to $200,000,000, PENN CENTRAL had at most $135,285,816 in accounts receivable (according to its Balance Sheet, [PX 68, Exhibit 1] to offset the $150,000,000 in outstanding commercial paper. This fact did not preclude WILSON from incorrectly testifying that at all times PENN CENTRAL'S accounts receivable exceeded the amount of commercial paper it had outstanding [WILSON Dep. 726, Tr. 851].

**"We[GOLDMAN, SACHS] provide for industrial, commercial, finance, transportation, agricultural and utility companies short-term funds for "current" transactions under an exemption -- 3(a)(3) -- from the prospectus and registration requirements of Section 5 of the Securities Act of 1933." [PX 84] (Emphasis supplied)

was not aware of any instance in which the proceeds of commercial paper sales were used for any purpose other than current operations [Tr. 366] and WILSON testified that he:

> "viewed the use of commercial paper of short-term borrowing [by PENN CENTRAL] from either the banks or ourselves in the paper market, that this was to be used for working capital purposes during that period of time while they [PENN CENTRAL] made these [merger related] efficiencies" [Tr. 850].

Although it was GOLDMAN, SACHS' policy to ascertain that an issuer was using the proceeds of its commercial paper sales for current purposes [Tr. 368, 369, 843] that was not done in the case of PENN CENTRAL [Tr. 970, VOGEL Dep. 226, 223, VAN CLEAVE Dep. 41, 42]* because WILSON had been advised by counsel prior to the issuance of the PENN CENTRAL paper that the paper was exempt under §3(a)6) of the '33 Act, which section does not have a current transaction requirement for the use of proceeds [Tr. 846, 962, 963].**

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*The failure to ascertain the purposes for which the PENN CENTRAL commercial paper proceeds were used and the relationship between this omission and the creditworthy misrepresentation is discussed in more detail at Point II A, supra.

** Counsel's advice to WILSON was apparently not conveyed to VAN CLEAVE or VOGEL.

Accordingly, the failure of GOLDMAN, SACHS to disclose to the FOUNDATION that PENN CENTRAL was using its commercial paper proceeds for non-current transactions (and the ICC's concern with respect to the same), was a material omission. In addition, disclosure of such facts were necessary to make GOLDMAN, SACHS' representations not misleading, because the use of the proceeds and the ICC'S concern would have indicated that PENN CENTRAL was not creditworthy or at least evidenced GOLDMAN SACHS' inadequate credit investigation. In addition, in view of the testimony of VAN CLEAVE and LEMAY that commercial paper proceeds were always used for short-term purposes (as well as WILSON'S testimony that the proceeds of the PENN CENTRAL paper sales were to be used for working capital purposes), there is sufficient evidence for this Court to find that GOLDMAN, SACHS in selling PENN CENTRAL paper impliedly represented that the proceeds of such sales were to be used for current transactions. The §3(a)(6) exemption does not require a contrary result since the public, the FOUNDATION and indeed, VAN CLEAVE and VOGEL, were unaware of it. Consequently, the failure of GOLDMAN, SACHS to disclose that the proceeds of the sales of PENN CENTRAL commercial paper were used for non-current transactions was also a material misrepresentation (Beecher v. Able,

374 F. Supp. 341 (S.D.N.Y. 1974), Lehigh Valley Trust Co. v. Central Nat'l Bank of Jacksonville, 409 F. 2d 989 (5th Cir. 1969).

C. THE FRAUDULENT SCHEME OR COURSE OF CONDUCT OF GOLDMAN, SACHS

In addition to making material misrepresentations and omitting to state material facts, GOLDMAN, SACHS also engaged in a fraudulent scheme or course of conduct. The fraudulent scheme which was perpetuated by GOLDMAN, SACHS was preservation of the status quo in the commercial paper market until PENN CENTRAL became financially sound. GOLDMAN, SACHS was the largest commercial paper dealer in the country and realized substantial profits from the sale of commercial paper.* It was therefore in its best interest to perpetuate an active commercial paper market. To maintain an active market however, it was necessary for GOLDMAN, SACHS to continue to sell the commercial paper for PENN CENTRAL, the largest railroad in the United States, and, as a concommitant of the same, to not disclose information with respect to the precarious financial condition of PENN CENTRAL. The disastrous effect of discontinuing the sale of PENN CENTRAL commercial paper and disclosing the true financial throes of PENN CENTRAL was clearly demonstrated by the chaotic condition of the commercial paper

*See PX-125.

market after the PENN CENTRAL bankruptcy. GOLDMAN, SACHS' fear that the commercial paper market would collapse in connection with a PENN CENTRAL bankruptcy is evidenced by its "Opinion Regarding The Effects On The Commercial Paper Market Should Penn Central Go Into Bankruptcy" [PX-125] wherein, inter alia, it was stated:

> "In our opinion a Penn Central Bankruptcy will shatter the confidence in the commercial paper market for several months anyway. In a sixty day period the Dealer market might experience as much as a 30 to 40% runoff in outstandings."

To avoid the collapse of the market, and thereby insure that its commercial paper profits would not decline, GOLDMAN, SACHS entered upon a course of conduct which included the misrepresentations and omissions discussed herein for the purpose of keeping PENN CENTRAL in business until it could obtain the desperately needed long term financing [PX-12, 14, 15, 16, Tr. 902-905] and decrease its operating losses, both of which problems were to be remedied in the spring of 1970. However, PENN CENTRAL was unable to complete its long term financing* and its operating losses increased [PX-15, 16, 46]. Consequently, PENN CENTRAL filed its voluntary petition and GOLDMAN, SACHS'

*E.g., the $100,000,000 debenture offering of the Pennsylvania Company was never completed and the guarantee of the federal government was not forthcoming [Tr. 935, 939].

fraudulent practices ** were revealed.

Moreover, GOLDMAN, SACHS' fraudulent scheme was not inconsistent with its other actions during the period from September, 1969 through June, 1970. Thus, GOLDMAN, SACHS did not insist that PENN CENTRAL obtain additional bankline coverage since the same could not be acquired without the banks from whom the lines were sought learning of PENN CENTRAL'S tenuous financial condition. Similarly, it was not inconsistent for GOLDMAN, SACHS to sell PENN CENTRAL commercial paper to its substantial customers. To the contrary, such sales were necessary to perpetuate the market since GOLDMAN, SACHS only contemplated the necessity for "supporting" PENN CENTRAL until the spring of 1970 when third party funds would remedy PENN CENTRAL'S financial ailments. Indeed, everything which GOLDMAN, SACHS did is consistent with the overall scheme to perpetuate the status quo of the commercial paper market.

It is therefore submitted that in addition to the misrepresentations and omissions made by GOLDMAN, SACHS in connection with the sale of commercial paper to the FOUNDATION,

* Further examples of GOLDMAN, SACHS' fraudulent scheme are the fact that WILSON agreed with O'HERRON to postpone the February 9, 1970 inventory reduction until PENN CENTRAL had met with the banks from whom additional banklines were sought [PX-11] (see points concerning banklines and the inventory reduction) and the agreement between O'HERRON and WILSON that O'HERRON would not jeopardize GOLDMAN, SACHS' relationship with BROWN BROS. by making "out-of-the-ordinary reviews with BROWN BROS. in connection with the February 4, 1970 earnings announcement [PX-13] (see also the point concerning BROWN BROS. and creditworthiness).

supra, GOLDMAN, SACHS was engaged in a broader, more general scheme or course of business. Furthermore, it is clear that the FOUNDATION was unaware of the scheme by GOLDMAN, SACHS and it is beyond a peradventure of doubt that had such a course of conduct been known to the FOUNDATION it would not have purchased PENN CENTRAL commercial paper. Accordingly, the requisite causation between GOLDMAN, SACHS' fraudulent scheme or course of conduct to perpetuate PENN CENTRAL and the commercial paper market and the FOUNDATION'S purchase exists and therefore GOLDMAN, SACHS has violated Rule 10b-5(1) and (3).

POINT III

THE COURT SHOULD FOLLOW THE DECISION IN FRANKLIN v. LEVY, BY REASON OF THE DOCTRINES OF COLLATERAL ESTOPPEL AND JUDICIAL COMITY

The relevant facts, the factual and the legal issues in Franklin v. Levy are essentially identical to those in the instant action. The FOUNDATION placed an order for $600,000 of PENN CENTRAL commercial paper with GOLDMAN, SACHS on March 13, 1970. On March 16, 1970, the same day FRANKLIN purchased $500,000 of PENN CENTRAL commercial paper from GOLDMAN, SACHS, GOLDMAN, SACHS sold the commercial paper to the FOUNDATION. In addition, the same misrepresentations and omissions were made by GOLDMAN, SACHS in connection with the purchases by the FOUNDATION and FRANKLIN. Thus, the circumstances of each purchase were the same*.

Simiarly, as indicated, infra, the factual and legal issues which were decided by Judge Metzner are iden-

*The only potentially relevant variation between the facts in Franklin and those in the instant case is that the FOUNDATION purchased its commercial paper through its agent, the UNION BANK, whereas FRANKLIN purchased directly. However, as discussed in Point V, infra, the special agency relationship between the FOUNDATION and UNION BANK is irrelevant to the rights and obligations between the FOUNDATION and GOLDMAN, SACHS. The only conceivable issue where the agency relationship might be pertinent is with respect to the knowledge of the FOUNDATION. In this regard, however, the sophistication and access of Mr. Bock, FRANKLIN'S President, was far superior to that of either LeMAY or FITZPATRICK and therefore, in the context of the legal issues which are relevant herein, would not undermine the effect of the Franklin decision. Indeed, if anything, the superior knowledge of FRANKLIN presents a stronger case for the FOUNDATION.

ical to some of those in the instant case*. Accordingly, this case is ideally suited for application of the doctrines of collateral estoppel and judicial comity.

As is relevant to the action of the FOUNDATION, Judge Metzner concluded with respect to the FRANKLIN purchase** that:

> (a) PENN CENTRAL commercial paper sold on March 16, 1970 was not exempt from §10b of the '34 Act.
>
> (b) GOLDMAN, SACHS failed to disclose to FRANKLIN that BROWN BROS. had removed PENN CENTRAL commercial paper from its approved list and that on February 9, 1970 GOLDMAN, SACHS had required PENN CENTRAL to repurchase from GOLDMAN, SACHS' inventory $10,000,000 of PENN CENTRAL commercial paper (jointly referred to herein as the "omitted facts");
>
> (c) The omitted facts were material;
>
> (d) The omitted facts should have been disclosed by GOLDMAN, SACHS;
>
> (e) Reliance is not required to be established under §10b of the '34 Act;
>
> (f) The omitted facts were necessary to make statements made, in light of the circumstances under which they were made, not misleading;

*Judge Metzner did not decide state securities law claims and claims under the common law. In addition, he did not consider all of the misrepresentations and omissions which are alleged by the FOUNDATION. Nevertheless, the issues decided in Franklin with respect to §10(b) and §12(2) are dispositive of the FOUNDATION'S action except with respect to the amount of prejudgment interest.

**The following issues were clearly determined by Judge Metzner in his decision, which, pursuant to the Judgment filed in Franklin v. Levy, represented the findings of fact and conclusion of law. Other determinations were of necessity implicit in connection with the same. Accordingly, the imposition of liability under §10(b) and §12(2) justifies the inference that all legal requirements necessary for recovery pursuant to such sections which may not have been expressly considered by Judge Metzner were nevertheless resolved in favor of FRANKLIN, e.g. the knowledge of FRANKLIN and GOLDMAN, SACHS.

(g) By failing to disclose the omitted facts to FRANKLIN, GOLDMAN, SACHS violated §10b;

(h) GOLDMAN, SACHS represented that PENN CENTRAL commercial paper was NCO prime on March 16, 1970;

(i) PENN CENTRAL commercial paper ceased to be prime on February 4, 1970;

(j) PENN CENTRAL commercial paper was not prime on March 16, 1970;

(k) On February 4, 1970, GOLDMAN, SACHS had no "faith" in the PENN CENTRAL commercial paper and was reducing its exposure.

As in Franklin, the FOUNDATION has alleged, inter alia, that GOLDMAN, SACHS failed to disclose the above omitted facts, thereby violationg §10b and §12(2). In connection with such allegations, it is contended that the omitted facts were material and that GOLDMAN, SACHS had a duty to disclose the omitted facts.* The Franklin decision resolved all of these issues (as well as other issues by implication) in favor of FRANKLIN and predicated the liability of GOLDMAN, SACHS on them. Since there is no significant difference between the facts and the factual and legal issues in Franklin and those which are dispositive of the FOUNDATION'S action, it is submitted that pursuant to the doctrine of collateral estoppel, GOLDMAN, SACHS is precluded from "relitigating" these issues in the case at bar. In any event, the Court should follow the precedent established by Judge Metzner in the Franklin decision as a matter of judicial comity.

*Either as a bare omission or to make other statements not misleading.

A. THE DOCTRINE OF COLLATERAL ESTOPPEL

The doctrine of collateral estoppel was developed to prevent a party from relitigating an issue which has been resolved in a prior action. Bruszewski v. United States, 181 F. 2d 419 (3rd Cir. 1950); Vincent v. Thompson, 79 Misc. 2d 1029, 361 N.Y.S. 2d 282 (Sup. Ct. Nassau Co. 1974). Collateral estoppel may be asserted offensively (as opposed to defensively) when, as here, it is invoked by a plaintiff to preclude relitigation of an issue by a defendant when the plaintiff was not a party to the prior action wherein the issue was determined. See Zdanok v. Gliddin Co., 327 F. 2d 944 (2d Cir. 1964). To warrant application of the doctrine offensively, it is necessary to establish that:

> (1) The party against whom the estoppel is asserted was a party to the prior action;
>
> (2) The issue to be estopped was identical to that in the prior action;
>
> (3) The party against whom the estoppel is asserted had a full and fair opportunity to litigate the issue in the prior action; and
>
> (4) the issue to be estopped was necessary to the judgment in the prior action.

See Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation, 402 U.S. 313 (1971); Zdanok v. Glidden Co., supra; James Talcott, Inc. v. Allahabad Bank, Ltd., 444 F. 2d 451 (5th Cir. 1971); Schwartz v. Public Administration of the County of Bronx, 24 N.Y. 2d 65 (1969). Each of these pre-

requisites is satisfied under the instant circumstances. GOLDMAN, SACHS was the defendant in Franklin. As shown above, each of the issues which the FOUNDATION seeks to estop are identical to those litigated in and necessary to the Franklin decision. Moreover, GOLDMAN, SACHS clearly had a full and fair opportunity to litigate each issue. Consequently, the only possible impediment to estopping a relitigation of the Franklin issues by GOLDMAN, SACHS is the requirement of mutuality.

In the past, unless the party asserting the estoppel was subject to being similarly collaterally estopped by his adversary, mutuality was not present and collateral estoppel could not be invoked. The necessity for mutuality as a prerequisite to collateral estoppel, however, is no longer required. Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation, 402 U.S. 313 (1971); Zdanok v. Glidden Co., 327 F. 2d 944 (2d Cir. 1964); SEC v. Kelly, Andrews & Bradley, Inc., 385 F. Supp. 948 (S.D.N.Y. 1974). See also, Currie, Civil Procedure: The Tempest Brews, 53 Calif. L. Rev. 25 (1961)) and Currie, Mutuality of Collateral Estoppel: Limits of the Bernhard Doctrine, 9 Stan. L. Rev. 281 (1957).

The cases of Divine v. Commissioner of Internal Revenue, 500 F. 2d 1041 (2d Cir. 1974) and Fink v. Coates, 323 F. Supp. 988 (S.D.N.Y. 1971) do not support a contrary conclusion in connection with the requirement of mutuality. In

Divine, the Court refused to apply collateral estoppel under the facts which were presented therein because the case was peculiar to issues of taxation and because the (Second Circuit) Court was, in effect, being asked to follow precedent which had been established in the Seventh Circuit. As a consequence of these two factors, the Court did not apply the doctrine of collateral estoppel because to do so would irresponsibly inhibit the necessary resolution of complex federal tax issues by the Supreme Court. Thus, in his concurring opinion, Judge Friendly stated that the doctrine was not applied because of "special factors relating to federal tax litigation..." Divine v. Commissioner of Internal Revenue, supra, at 1057 (2d Cir. 1974). The instant case involves neither an issue of federal taxation nor the estoppel of an issue which has been resolved in another Circuit.

Similarly, the case of Fink v. Coates, is inapposite. In that case, the Court declined to apply the doctrine of collateral estoppel because (a) the prior litigation which resolved the issue to be estopped was on appeal, (b) the defendant did not have a full and fair opportunity to litigate the issue to be estopped (by implication) because the prior litigation was "relatively small" compared to the pending action, (c) there were no specific findings of fact or conclusion of law by the Court with respect to the issue to be estopped, and (d) the case concerned issues of

scienter, falsity and materiality (as opposed to the interpretation of a contract) as to which there were contradictory findings within the Second Circuit.

However, none of these factors precludes the application of collateral estoppel in the instant case. The fact that the decision in Franklin v. Levy, may be appealed is irrelevant since the same is a final judgment. See 1B Moores, Federal Practice ¶0.413[3], p. 2251 [1974]. The liability of GOLDMAN, SACHS in Franklin is commensurate with that sought by the FOUNDATION and therefore GOLDMAN, SACHS is presumed to have fully and fairly litigated the issue to be estopped. In the judgment filed in Franklin, Judge Metzner indicates that his findings of fact and conclusion of law are contained in his decision.

While the nature of certain of the issues sought by the FOUNDATION to be collaterally estopped involved falsity, materiality and scienter, it is submitted that refusal to apply the doctrine on that ground is unwarranted. As indicated in Divine, the Fink Court did not apply collateral estoppel to the issues of scienter, materiality and falsity not only because such issues were susceptible of "varying appraisals" but also, and more significantly, because varying appraisals of such issues had already been made in the same Circuit:

> "...In refusing to apply collateral estoppel [in Fink], Judge Bonsal ... distinguished Zdanok, at least partially, on the ground that the issue in Zdanok was one the resolution of which would be

> the same in any forum. As evidence of the fact that the issue of the defendants' knowledge of falsity was a difficult one and one subject to varying appraisals, the court adverted to the language of judges of the Second Circuit and the Southern District of New York rendered during the course of the principal Texas Gulf Sulphur litigation, which language fell short of stating that there was knowledge of falsity... These judicial views were thus incompatible with the opinion of the district court for the District of Utah and clearly demonstrated that the resolution of the legal issue of knowledge of falsity might very well differ from forum to forum." Divine v. Commissioner of Internal Revenue, supra, at 1047.

It is submitted that the Fink Court must have based its refusal to apply the doctrine of collateral estoppel not on the ground that varying appraisals of the issues could have been made but rather on the ground that varying appraisals had already been made. If the basis for the Court's refusal was because "varying appraisals" of the issues could have been made, no issue would ever be susceptible of being collaterally estopped because an issue which could not be variously appraised would not ordinarily be the subject of a litigation. It must therefore be concluded that the Court in Fink v. Coates actually declined to collaterally estop the issues of scienter, materiality and falsity on the ground that there already existed conflicting findings in connection with those issues within the Second Circuit and not because such issues

were capable of contradictory resolution. Consequently, since there presently exist no varying appraisals of the issues sought to be estopped by the FOUNDATION, the Fink decision does not preclude application of the doctrine.

Accordingly, GOLDMAN, SACHS should be estopped from relitigating the issues which were resolved in Franklin. In this connection, it should be noted that although collateral estoppel is generally asserted prior to a retrial of the same issues, the doctrine has been invoked in situations where the issue sought to be estopped has already been relitigated. Thus, in Zdanok v. Glidden Co., supra, when action #1 was relitigated on the basis of new evidence, action #2 was joined with action #1 and litigated at the same time. On appeal, the Second Circuit held that the issue resolved in favor of the plaintiffs in the original litigation of action #1 (as opposed to the relitigation) could be asserted offensively by the plaintiffs in action #2. Based on the foregoing and the similarity between Franklin and the instant action, GOLDMAN, SACHS should be collaterally estopped from "relitigating" the issues decided by Judge Metzner in Franklin. Accordingly, for purposes of the FOUNDATION'S action, the issues discussed, supra, should be deemed resolved and GOLDMAN, SACHS be found to have violated §10(b) of the '34 Act and §12(2) of the '33 Act.

B. THE DOCTRINE OF JUDICIAL COMITY

In addition to the doctrine of collateral estoppel, the Court should defer to the decision of Judge Metzner in Franklin with respect to the issues which are relevant to the FOUNDATION'S action on the basis of judicial comity. Although the doctrine of comity is admittedly not absolute, "...the rule is a most salutary one", and necessary "to preserve the orderly functioning of the judicial process". (TCF Film Corporation v. Gourley, 240 F. 2d 711, 713 (3rd Cir. 1957). As was stated in Dix v. Brownell, 141 F. Supp. 789, 792 (E.D.N.Y. 1956):

> "...While the doctrine between co-ordinate judges is one of comity, Munro v. Post, 2 Cir. 102 F. 2d 686, Bowles v. Wilke, 7 Cir., 179 F. 2d 35, certiorari denied, 388 U.S. 861, 70 S. Ct. 104, 94 L. Ed. 528, and is not as binding as res judicata, United States v. U.S. Smelting, Refining & Min. Co., 339 U.S. 186, 70 S. Ct. 537, 94 L. Ed. 750, it is an orderly rule which should be followed generally. In re Hines, 2 Cir., 88 F. 2d 423; Commercial Union of America v. Anglo-South American Bank, 2 Cir., 10 F. 2d 937; Aachen & Munich Fire Insurance Co. v. Guaranty Trust Co., D.C. S.D.N.Y., 24 F. 2d 465."

In approving the doctrine on the grounds that it is beneficial to conclusively end litigation and preserve the precedential status of stare decisis, the Second Circuit has indicated that the doctrine in applicable not only in the same case but in different actions as well. See Dictograph Products Company v. Sonotone Corporation, 230 F. 2d 131 (2d Cir. 1956) and Commercial Union of America, Inc. v. Anglo-South American

Bank, Ltd., 10 F. 2d 937 (2d Cir. 1925). Consequently, regardless of the fact that the doctrine of judicial comity is not imperative, it is submitted that by reason of the identity of issues between Franklin v. Levy and the instant case and the precedential value which should be accorded the well reasoned decision of Judge Metzner, this case presents the ideal circumstances for adopting the doctrine.

POINT IV

PENN CENTRAL COMMERCIAL PAPER WAS A "SECURITY" AND THEREFORE NOT EXEMPT FROM THE ANTI-FRAUD PROVISIONS OF THE SECURITIES EXCHANGE ACT OF 1934

GOLDMAN, SACHS maintains that the PENN CENTRAL commercial paper purchased by the FOUNDATION is not a security and therefore is not subject to the antifraud provisions of the '34 Act. The facts of the instant case, however, do not support this contention.

Section 3(a)(10) of the '34 Act defines a security which is exempt as:

> "...any note ... but shall not include ... any note ... which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

However, because of the broad remedial purpose of the federal securities laws, and the '34 Act in particular, the Courts have adopted the standards set forth in SEC Release No. 4412 in determining whether a particular note is exempt from the '34 Act pursuant to §3(a)(10). Sanders v. John Nuveen & Co., Inc., 463 F. 2d 1075 (7th Cir. 1972); Zeller v. Bogue Electric Manufacturing Corporation, 476 F. 2d 795 (2d Cir. 1973);

Welch Foods, Inc. v. Goldman, Sachs & Co., [1974-1975] CCH Fed. Sec. L. Rep. ¶94,806 at 96,680 (S.D.N.Y. 1974); and Franklin v. Levy. Pursuant to SEC Release No. 4412, to be exempt from the anti-fraud provisions of the '34 Act, the commercial paper must be:

1. Of prime quality;
2. Of a type not ordinarily purchased by the general public;
3. Issued to facilitate well recognized types of current operational business requirements; and
4. Of a type eligible for discounting by Federal Reserve Banks.

As indicated herein, when the FOUNDATION purchased the PENN CENTRAL commercial paper from GOLDMAN, SACHS, the commercial paper failed to satisfy any of these criteria and, accordingly, was not an exempt security.

In determining whether the PENN CENTRAL commercial paper was prime on March 16, 1970, the generic meaning of prime, i.e. "first in value or excellence; or excellent quality; first rate", should be utilized based upon objective data.* Welch Foods, Inc. v. Goldman, Sachs & Co., supra. Based upon this standard, the PENN CENTRAL commercial paper was clearly not prime on the date of purchase as evidenced by its lack of creditworthiness, the inability of

*Reliance on NCO'S prime rating of the PENN CENTRAL commercial paper was rejected by the Welch Court as well as by Judge Metzner in Franklin v. Levy.

PENN CENTRAL to obtain 100% bankline coverage for its outstandings, and GOLDMAN, SACHS' resale of $10,000,000 of PENN CENTRAL inventory to PENN CENTRAL and its imposition of a $5,000,000 inventory limit with respect to the same.* Accordingly, the Court in Welch noted that:

> "Enough objective data was known in early 1970 to lead a reasonable observer to conclude that the commercial paper was not prime, and indeed the issuer became insolvent very shortly thereafter. This fact alone is some evidence that the paper was not "prime" at the time of sale." Welch Foods, Inc. v. Goldman, Sachs & Co., supra, at 96, 684.

Likewise, in Franklin v. Levy, Judge Metzner concluded:

> "I find, for the reasons explained below in discussing the merits of the litigation, that this note bought by Franklin on March 16, 1970, was not prime commercial paper at the time of purchase, and was not exempt from the provisions of Section 10(b). (p. 13)
>
> * * *
>
> It is an unescapable conclusion that starting with February 4, GOLDMAN, SACHS just did not have faith in this paper any more and was lightening its load and reducing its exposure. At this point I find that the paper could no longer be considered prime paper and quality for an exemption from the provisions of Section 10(b)." (p. 19)

Similarly, the PENN CENTRAL commercial paper was ordinarily purchased by the general public.

> "The definition of the term 'general public' should not be narrowly construed. Large as well

*See the factual discussions, supra, dealing with these omissions and representations.

> as small investors are protected by the Securities Acts. '[S]ophisticated investors, like all others, are entitled to the truth.' Stier v. Smith, 473 F. 2d 1205, 1207 (5th Cir. 1973)." Welch Foods, Inc. v. Goldman, Sachs & Co., supra, at 96,685.

Employing this definition, the Welch Court concluded that:

> "Even if the majority of the purchases of PENN CENTRAL notes were large financial institutions who purchased in large amounts, individuals and businesses of medium size could and did purchase the paper, not only directly from GOLDMAN, SACHS, but also through banks and trust companies, which in turn purchased from GOLDMAN, SACHS. Partners of GOLDMAN, SACHS understood[*] that these banks were purchasing not solely for their own account, but for the account of various banking customers, including individuals, personal trusts and business firms." Id.

In the context of the FOUNDATION'S purchase, FITZPATRICK was clearly not a sophisticated investor, and as the Welch Court indicated, the fact that the purchase was effectuated by the UNION BANK is irrelevant.* Accordingly, PENN CENTRAL commercial paper was ordinarily purchased by the general public and therefore the second criterion of SEC Release No. 4412 was not satisfied.

With respect to the third prerequisite for exemption, the PENN CENTRAL commercial paper was not utilized to "facilitate well recognized types of current operational business requirements". To the contrary, "proceeds of the PENN CENTRAL

*See also Point V, infra.

commercial paper were being used directly or indirectly to fund past capital expenditures and matured debt obligations, rather than for traditional current expenses..." Welch Foods, Inc. v. Goldman, Sachs & Co., supra, at 96,685.* Indeed, PENN CENTRAL'S application to the ICC dated September 11, 1969 to increase its outstanding commercial paper states that "the proceeds of the sale of the commercial paper notes will be used to reimburse the Treasury of ... [PENN CENTRAL] in part for past capital expenditures and matured debt obligation and to replenish its cash" [PX-68] and the ICC decision approving the increase notes that [PX-64]:

> "The exhaustion of short-term credit to refinance maturing long-term debt or to finance long-term capital expenditures could expose a carrier to a serious crisis in the event of an economic squeeze, at which time a carrier may require short-term financing for traditional use. We are, therefore, concerned about the use of short-term financing for long-term purposes and feel that where necessary it should be resorted to cautiously."

Consequently, it is clear that the PENN CENTRAL commercial paper was not utilized to facilitate current business requirements. Similarly, because eligibility for discounting by the Federal Reserve Banks is dependent, at least in part, on meeting the current expense standard (cf. 12 C.F.R. §201), the acknowledged use of PENN CENTRAL commercial paper for non-current expenses automatically disqualified it from eligibility

*See also the factual discussion with respect to the current transactions omission, supra.

for discounting by the Federal Reserve. Accordingly, the PENN CENTRAL commercial paper does not meet either of the final two elements of SEC Release No. 4412.

Thus, PENN CENTRAL commercial paper does not qualify for the exemption under §3(a)(10) of the '34 Act as interpreted by the SEC and the aforementioned cases. Therefore, PENN CENTRAL commercial paper is a "security" under the '34 Act and consequently subject to its provisions and §10b.

POINT V

THE AGENCY RELATIONSHIP BETWEEN THE FOUNDATION AND THE UNION BANK IS IRRELEVANT TO THE RIGHTS AND OBLIGATIONS BETWEEN THE FOUNDATION AND GOLDMAN, SACHS

The FOUNDATION purchased the PENN CENTRAL commercial paper from GOLDMAN, SACHS through its agent, the UNION BANK. As indicated in its Trial Brief*, GOLDMAN, SACHS will presumably argue that any information known to the UNION BANK with respect to PENN CENTRAL is imputable to the FOUNDATION by virtue of the principal-agency relationship between them. It is submitted, however, that because (1) GOLDMAN, SACHS did not establish that the UNION BANK possessed any significant information about PENN CENTRAL and (2) the UNION BANK was the special agent of the FOUNDATION, the fact that the UNION BANK was a party to the purchase of the PENN CENTRAL commercial paper is irrelevant and of no legal consequence.

The record indicates that the extent of the cumulative knowledge of LeMAY, the Vice President of the Investments Division of the UNION BANK and the person with whom the FOUNDATION dealt with respect to its purchase of the PENN CENTRAL commercial paper, and the UNION BANK in general,

*DTB-97.

was as follows:

(1) The New York Central and Pennsylvania Railroad merged, which merger was to result in eventual savings [Tr. 72-73];

(2) PENN CENTRAL was suffering operating losses* [Tr. 78];

(3) The newspapers reported unfavorable information about PENN CENTRAL [Tr. 79]; and

(4) The information contained in Moody's Transportation Record, Standard & Poors, Dun & Bradstreet and NCO (and the supplements thereto) were generally available at the UNION BANK [Tr. 82-83].

Assuming that the foregoing information was imputable to the FOUNDATION, the limited scope and general nature of the same would not preclude the FOUNDATION from recovery. Moreover, except with respect to the losses of PENN CENTRAL, none of the information relates to the misrepresentations or omissions of GOLDMAN, SACHS, e.g. an adequate credit investigation, the removal by BROWN. BROS. HARRIMAN, the banklines, the inventory repurchase and limitation. Thus, the only knowledge which possibly would be relevant would be that regarding the fact that PENN CENTRAL was suffering operating losses. However, because it was not known that the losses were increasing or that the losses were in excess of those predicted by the PENN CENTRAL management, such information can not be deemed significant.

*Although it was not known that such losses were increasing.

In any event, the nature of the agency relationship between the FOUNDATION and the UNION BANK does not permit the imputation of any knowledge to the FOUNDATION. The general rule is that:

> "The principal is bound by notice to or knowledge of his agent in all matters within the scope of his agency although in fact the information may never actually have been communicated to the principal." Schuller v. The Slick Corporation, [1974-75] CCH Fed. Sec. L. Rep. ¶95,065 at 97,736, 97,739 (S.D.N.Y. 1975) (Emphasis Supplied).

Consequently, not all knowledge is imputed from the agent to the principal. It is only the knowledge concerning matters within the scope of the agency which is imputable.

In the instant case, the UNION BANK was a special agent* of the FOUNDATION with the scope of its agency being limited to the purely ministerial act of effectuating the purchase decision of the FOUNDATION. FITZPATRICK called LeMAY and said the FOUNDATION had $600,000 it want to invest in prime quality commercial paper at a specific rate

*"A general agent is an agent authorized to conduct a series of transactions involving a continuity of service. A special agent is an agent authorized to conduct a single transaction or a series of transactions not involving continuity of service." P. T. Perusahaan Pelayaran Samudera Trikora Lloyd v. T. S. Salzachtal, 373 F. Supp. 267, 277-278 (E.D.N.Y. 1974) [Emphasis in original] (Citations Omitted). "A special agent is defined as 'one authorized to do some particular act or to act upon some particular occasion. He acts usually in accordance with specific instructions or under limitations necessarily implied from the act to be done.' 1 Mechem, supra [Mechem on Agency (2d Ed. 1914) Section 61]". Donroy Ltd. v. United States, 301 F. 2d 200, 206 (9th Cir. 1962).

for a certain amount of time. LeMAY in turn advised the FOUNDATION of the three or four issuers communicated to him by GOLDMAN, SACHS. FITZPATRICK selected PENN CENTRAL commercial paper from those available and instructed LeMAY to purchase the same in behalf of the FOUNDATION. The UNION BANK did not act as an investment adviser [Tr. 58] or recommend a particular issuer [Tr. 59] and did not charge a fee for executing the transaction [Tr. 58]. Thus, the UNION BANK did not exercise any judgment with respect to the transaction. As succinctly stated by the Court,

> "The bank's role [was] ... to present its customer with as many names as it could get of people who were issuing or selling prime paper or the amount required ..." [Tr. 69, 70],

and,

> "What was good enough for Goldman, Sachs was good enough for you [Union Bank] to pass on to your [its] customers" [Tr. 68].

Furthermore, the FOUNDATION did not rely upon or expect UNION BANK to exercise any judgment or make any recommendation. The FOUNDATION relied on the UNION BANK solely to present it with a list of prime names [Tr. 135] it received from dealers. Accordingly, the scope of the agency of UNION BANK and its consequent duty did not encompass analyzing the financial status of an issuer, recommending a particular issuer's commercial paper or informing the FOUNDATION of any facts about an issuer other than whether its commercial paper was rated prime by others. Because the scope of the

agency was limited to merely effectuating the purchase or at best communicating whether commercial paper was rated prime, any knowledge the UNION BANK may have had beyond this scope would not be imputed to the FOUNDATION. Since the cumulative knowledge of LeMAY and UNION BANK relate to matters outside such scope, even if such knowledge were relevant, it is not imputable.

Similarly, the special agency of the UNION BANK renders the issue of constructive knowledge or what the UNION BANK should have known irrelevant.

> "The principal is not affected by the knowledge which an agent should have acquired in the performance of the agent's duties to the principal or to others, except where the principal or master has a duty to others that care should be exercised in obtaining confirmation." Restatement of Agency 2d §277.

As indicated above, the restricted scope of the agency of the UNION BANK imposed no duty upon it to acquire information other than with respect to conveying the fact that particular issuers were rated prime and effectuating the purchase. See Sanders v. John Nuveen & Co., Inc., [1975] CCH Fed. Sec. L Rep. ¶95,347 at 98,718 (7th Cir. 1975) and the comment and illustration to the Restatement of Agency 2d §277. Accordingly, what the UNION BANK should have known is not an issue in this case.

By reason of the foregoing, the relationship between the UNION BANK and the FOUNDATION does not alter or affect the rights and obligations between the FOUNDATION and GOLDMAN, SACHS. For all intents and purposes, because the UNION BANK was the special agent of the FOUNDATION with only limited authority to execute the purchase of PENN CENTRAL commercial paper from GOLDMAN, SACHS in behalf of the FOUNDATION, the instant transaction can be characterized, and should be analyzed, as a direct purchase of commercial paper from GOLDMAN, SACHS by the FOUNDATION.*

*There can be no doubt that GOLDMAN, SACHS knew or should have known that the UNION BANK was purchasing the commercial paper on behalf of a customer. Thus, VAN CLEAVE has testified that 99% of bank purchases of commercial paper are made on behalf of bank customers [Tr. 383, 384]. Of the three commercial paper salesmen in GOLDMAN, SACHS' Los Angeles office who dealt with LeMAY, one testified that he was aware that banks were purchasing for the account of customers [FREDERICKSEN Dep. 55], another testified that he was aware that the UNION BANK was buying commercial paper from GOLDMAN, SACHS for the account of its customers rather than its own account [DUERSON Dep. 46] and the salesman who wrote the letter to the UNION BANK confirming the subject sale testified:

> "Q. Were you aware of the fact that Union Bank was not purchasing for its own account?
>
> A. Yes.
>
> Q. How did you become so aware?
>
> A. It was not -- it was not Union Bank's policy to buy commercial paper, at least from Goldman, Sachs, to the best of my knowledge, for their own account. And I would normally presume that they would buy short and much larger quantities." [COLEMAN Dep. 64, 65]

POINT VI

THE STATE CLAIMS OF THE FOUNDATION ARE NOT MERGED INTO THE FEDERAL CLAIMS

As indicated under the Point dealing with the legal requirements for recovery under the federal and state securities laws, and under the common law, the elements with respect to each of these claims are not identical. For example, §25402 of the California Corporations Code explicitly predicates liability on "access, directly or indirectly, to material information about the issues not generally available to the public". Similarly, under the common law doctrine of innocent rescission, it is only necessary to establish the making of a material misrepresentation or omission. In addition, the computation of prejudgment interest in this case will vary by as much as $25,000 depending upon under which claim GOLDMAN, SACHS is held liable. Accordingly, the FOUNDATION should be permitted to obtain a judgment under any or all of its claims and select which claim it will execute upon which it will execute upon to provide it with the greatest amount of compensation for the injury caused by GOLDMAN, SACHS. Therefore, it is necessary to consider each of the FOUNDATION'S claims separately and no merger

of the same should occur. See Welch Foods, Inc. v. Goldman, Sachs & Co. [1974-1975] CCH Fed. Sec. L. Rep. ¶94,806, at 96,680 (S.D.N.Y. 1974) and Federal Rules of Civil Procedure Rule 8(e).

CONCLUSION

The evidence clearly demonstrates that in connection with the FOUNDATION'S purchase of PENN CENTRAL commercial paper, GOLDMAN, SACHS misrepresented that PENN CENTRAL was creditworthy and that GOLDMAN, SACHS had not performed an adequate credit investigation of PENN CENTRAL. In addition, GOLDMAN, SACHS did not disclose to the FOUNDATION that NCO'S prime rating of the commercial paper was predicated on GOLDMAN, SACHS continuing to sell it; GOLDMAN SACHS' futile efforts to have PENN CENTRAL obtain 100% bankline coverage for its outstanding commercial paper; that GOLDMAN, SACHS reduced its inventory of PENN CENTRAL commercial paper by $10,000,000 and imposed a $5,000,000 inventory limit; that BROWN BROS. removed PENN CENTRAL commercial paper from its approved list; that PENN CENTRAL was in a tight cash position, lacked working capital and had increasing losses; and that PENN CENTRAL was using the proceeds from its commercial paper sales for non-current transactions. Finally, the facts establish that GOLDMAN SACHS was engaged in a fraudulent scheme or course of conduct to perpetuate an active commercial paper market. By reason of the foregoing, GOLDMAN, SACHS has violated

the '34 Act, the '33 Act, §352-c of the New York General Business Law, §§25,401, 25,402, 25,501 and 25,502 of the California Corporations Code and has committed commmon law fraud. Accordingly, the FOUNDATION should be awarded damages in the amount of $600,000 plus interest from September 25, 1970, together with the costs of this action.

Respectfully Submitted,

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APPENDICES

APPENDIX A - DEPOSITION SUMMARIES

APPENDIX B - DECISION OF JUDGE METZNER IN FRANKLIN v. LEVY

APPENDIX C - NEW YORK GENERAL BUSINESS LAW §352-C

APPENDIX D - CALIFORNIA CORPORATIONS CODE §§24501 and 25501

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APPENDIX A - DEPOSITION SUMMARIES

APPENDIX A

The following are brief summaries of the portions of the deposition testimony of those individuals who did not testify at trial which is being offered by the FOUNDATION. The individuals are listed in alphabetical order and the numerals in parenthesis refer to page numbers in the deposition.*

ROBERT P. ANCZARKI

GOLDMAN, SACHS commercial paper salesman from July, 1968 to May, 1970 (4). After first quarter (1970) PENN CENTRAL earnings announced in April, 1970, he was instructed to advise investors of earnings (9). Told investors GOLDMAN, SACHS was largest in field and in commercial paper business for 100 years (18). Investors would ask about banklines and NCO rating of issuer (20) and whether NCO rating was prime (21). Responsible for following BROWN BROS. account and purchase PENN CENTRAL commercial paper (25). Told WILSON of BROWN BROS. decision (26). WILSON knew on February 6, 1970 of BROWN BROS. removal of PENN CENTRAL commercial paper from approved list (62). Sales on best efforts basis against special order meant GOLDMAN, SACHS held no inventory (65). Prime meant rated by NCO as prime which was the highest rating (105).

DAVID C. BEVAN

Chairman of the Finance Committee and Chief Financial Officer of PENN CENTRAL until April 1, 1970 (10). Does not recall February 6, 1970 luncheon meeting with GOLDMAN, SACHS (32). PENN CENTRAL needed $100 Million in financing for 1970, exclusive of equipment (38). PENN CENTRAL contemplated a $50 to $100 Million bond offering in late 1970, the proceeds from which would reduce outstanding commercial paper or the revolving credit (40-41). GOLDMAN, SACHS said it has investors who would only buy commercial paper if it has 100% bankline coverage but 100% coverage was difficult to obtain because of the tight market and some banks were at their legal limits or would not take on new customers (47-48). Did not speak with ALAN ROGERS of NCO in first four months of 1970 (62). GOLDMAN, SACHS

*Portions of the deposition summaries of the following individuals may not have been designated by the FOUNDATION.

was told that $100 Million debenture Eurodollar financing would carry PENN CENTRAL through 1970 (84). Ultimately, the government did not guarantee the loan to PENN CENTRAL in spring, 1970 (92). In February, 1970, PENN CENTRAL told GOLDMAN, SACHS that it had trouble getting confirmed lines, that money was tight and there were restrictions on lending (i.e. banks would not lend if there were no prior banking relation or if a prior relation existed) and the banks were close to their lending limits (93-94). On October 29, 1969, ICC permitted PENN CENTRAL to increase commercial paper outstandings from $150 to $200 Million (95). Does not know if GOLDMAN, SACHS updated its credit investigation in connection with the ICC increase (101, 106). GOLDMAN, SACHS did not ask PENN CENTRAL how commercial paper proceeds were to be used and some were not earmarked (103-106). Contacts at GOLDMAN, SACHS were LEVY and WILSON (114). The Pittsburg, Cleveland, Great Southwest, Arvida, Buckeye, and Madison Square Garden properties were not sold (120-121). Does not know of GOLDMAN, SACHS' investigation of PENN CENTRAL'S financial condition (128). Cash situation of PENN CENTRAL in fall, 1969 was very tight (148). When PENN CENTRAL passed its October, 1969 dividend does not recollect any attempts by anyone to call him regarding the same (206). In fall, 1969 and thereafter GOLDMAN, SACHS requested greater than 50% bankline coverage (208). GOLDMAN, SACHS said there were commercial paper investors who would only buy commercial paper with 100% bankline coverage (209). GOLDMAN, SACHS was told that PENN CENTRAL'S budgeting was based on 1969 results and that the first quarter results of 1970 would be poorer (214). $100 Million debenture offer was discussed with GOLDMAN, SACHS (217). Does not recall if GOLDMAN, SACHS asked how fast PENN CENTRAL properties could be sold (233).

PAUL K. BRENKERT

Commercial paper salesman at GOLDMAN, SACHS since October, 1969 (3). Investors asked questions concerning NCO ratings, banklines, GOLDMAN, SACHS' inventory position, and cash flow of PENN CENTRAL and PENN CENTRAL commercial paper (9)(22). Investors asked about nature of GOLDMAN, SACHS' credit investigation (19).

G. CLIFFORD COLEMAN

GOLDMAN, SACHS commercial paper salesman in Los Angeles Office from October, 1967 through January, 1971 (5-9). Customers did inquire about banklines of credit (22-23). NCO rating of an issuer was used as a sales de-

vice (32). Dealt with the UNION BANK but was not the primary salesman (48). Wrote the letter of confirmation dated March 13, 1970 in connection with the FOUNDATION'S purchase but did not make the offer to LeMAY. Knew UNION BANK was not purchasing for its own account (64-65, DUERSON had primary responsibility for the UNION BANK account (110-111). UNION BANK only wanted prime commercial paper (113-114).

DONALD DUERSON

GOLDMAN, SACHS commercial paper salesman from March, 1969 through January, 1971 (4-5). Inquiries of customers concerned ratings, banklines and earning trends (18-22, 33-34). He did not participate in the FOUNDATION'S purchase although he had dealt with LeMAY and knew UNION BANK bought for accounts of its customers (42-46). Prime means NCO prime or quality paper (97).

CHARLES H. DUFFY

Manager of GOLDMAN, SACHS Note and Discount Department in 1968 through 1970 which Department receives and delivers commercial paper (3-4).

MICHAEL L. EVANS

Credit analyst in GOLDMAN, SACHS Commercial Paper Department from September, 1968 through January 14, 1970 (4). No formal training program at GOLDMAN, SACHS (6). When he left GOLDMAN, SACHS, ROBERT HOFFMAN succeeded to his duties (7). No experience or background in commercial paper (10). Duties at GOLDMAN, SACHS included analytical review of commercial paper issuers from annual reports and other documents and updating same. Reviews done once or twice a year and were written (11). Reported to FEKULA, VOGEL and WILSON (12). Prepared written reviews of annual financial statements of issuers (13). Does not recall reading any memoranda of, or being consulted by GOLDMAN, SACHS' Research Department in connection with, PENN CENTRAL (23). Prior to selling commercial paper of an issuer, GOLDMAN, SACHS would conduct a credit investigation which consisted of preparing a list of financial or other information about the issuer (23). Other analysts at GOLDMAN, SACHS were O'DONNEL, HOFFMAN, ANCZARKI, TULLY, FEKULA (26). In connection with the credit analysis, he did not consult with the prospective issuer other than to obtain documents (30). Does not recall consulting anyone outside GOLDMAN, SACHS in connection with analyses (32). After GOLDMAN, SACHS commenced selling commercial paper of an issuer, a continuing credit investigation occurred pursuant to which the

annual report, internal GOLDMAN, SACHS memos and documents pertaining to the issuer are analyzed (34-35). Frequency of review of issuer depended in part on events which occurred (36). Does not know if GOLDMAN, SACHS conducted a credit investigation of PENN CENTRAL before selling its commercial paper and he did not recall participating in the initial credit investigation or see any report of the same (39, 42). At some point, assigned as credit analyst to cover PENN CENTRAL (40). Followed PENN CENTRAL in 1969 by reviewing annual report of PENN CENTRAL, preparing yellow and green sheets, reading blue sheets, interim reports, Dun & Bradstreets and bank checkings (40-43). Banklines are important to any company (46). Does not know or recall if PENN CENTRAL credit investigation was ever updated after November, 1969 or if he or anyone else was requested to do so (50-53). During the time he handled PENN CENTRAL, PENN CENTRAL had a tight cash position, negative working capital and increasing debt to equity but he did not recall discussing the same with FEKULA or VOGEL (58-59). He prepared written annual review of 1968 financial statements of PENN CENTRAL when annual report published and in connection therewith reviewed the annual report, credit file, Dun & Bradstreet report and loan agreements of PENN CENTRAL. The review indicated that PENN CENTRAL had capital problems, insufficient depreciation and long term financing, negative net working capital position, $50,000,000 of commercial paper carried as long term debt, current assets less than current liabilities, extended debt ratio, and deterioration of the balance sheet (62-71). He does not recall any conversations with anyone from PENN CENTRAL (80).

WALTER P. FEKULA

Assistant to VOGEL in Credit Department in 1969 through 1970 (3). He supervised daily operations and activities of Credit Department, credit analysts and other personnel (4). In 1969/1970, EVANS, TULLY, HOFFMAN, STROMING, O'DONNELL, DEMBROW and KENSETH were credit analysts although there were only four or five at one time (7-8). Bank checkings to confirm credit facility of banks to issuer were done by analysts or college trainees. There was no set form of inquiry for the checkings (9). In 1968 through 1970, the Credit Department followed 200 to 225 issuers with each analyst responsible for about 50 issuers (13). Analysts reported to FEKULA and FEKULA would review work of analysts (15). If VOGEL wanted an additional credit investigation of an issuer, FEKULA would be responsible for it (15). Interim financial information regarding an issuer would be obtained depending on the credit of the issuer (20). A review of an issuer was done annually unless interim financial information was obtained (29). The function of the Credit Department was to review creditworthiness of an issuer (34). Initial credit review of an issuer consisted of reviewing and analyzing financial statements, credit facilities

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and bank checkings and other documentation regarding creditworthiness of the issuer (41-46). Initial credit review is written by analyst, given to FEKULA and then to VOGEL (50). VOGEL would review information and determine if the issuer should be in the commercial paper market but WILSON had the ultimate responsibility as to whether to sell commercial paper (52-53). In 1968 through 1970, WILSON reported to WHITEHEAD or WEINBERG (54). Further financial information obtained from GOLDMAN, SACHS' Corporate Finance and Research Departments (56). Continuing credit investigation includes annual review of financial statements and other information and bank checkings (59). Fiscal review of financial statements of an issuer was done once a year (59) although a further review may be conducted based on other knowledge acquired about an issuer (61). VOGEL and FEKULA would review each issuer at least once a year (63). Credit analysts did not maintain regular contact with officers of an issuer (64). MICHAEL EVANS made the initial credit investigation of PENN CENTRAL for GOLDMAN, SACHS but FEKULA never saw a report of the initial credit investigation (66). He has no recollection of doing anything other than obtaining documents in connection with the PENN CENTRAL credit investigation (68). ROBERT HOFFMAN was the PENN CENTRAL credit analyst after EVANS resigned (74). EVANS wrote a credit review of PENN CENTRAL'S 1968 financial statements and followed PENN CENTRAL thereafter but EVANS did nothing out of the general routine in connection with PENN CENTRAL (75-76). He has no knowledge as to whether EVANS referred to materials other than financial statements in preparing analysis (81-83). In May, 1970 HOFFMAN prepared a review of PENN CENTRAL'S 1969 financial statements which was sent directly to VOGEL, but he has no knowledge of what HOFFMAN or VOGEL did regarding the continuing credit investigation (83-86). In February, 1970, VOGEL was supervising the PENN CENTRAL credit investigation (87). FEKULA never had any contact with PENN CENTRAL officers (104). Other than the financial statements, he does not know if EVANS or HOFFMAN used any other information in preparing the reviews (107). The purpose of the reviews was to determine if GOLDMAN, SACHS should continue to be the dealer for an issuer (107). Credit reviews were based upon the consolidated statements of PENN CENTRAL (116).

CARL A. FREDERICKSEN

Commercial paper salesman and manager of GOLDMAN, SACHS' Los Angeles Office from 1967 through 1971 (4-14). Credit questions from customers pertained to banklines, net worth, sales, liquidity, NCO ratings and working capital of an issuer (22-24). He told customers that PENN CENTRAL was rated prime by NCO (39). In dealing with the UNION BANK, he does not recall any sale of commercial paper which was other than NCO

prime commercial paper (92). He believes COLEMAN handled the FOUNDATION'S purchase on March 13, 1970 (92-93).

ROBERT HANSELL

Commercial paper salesman in GOLDMAN, SACHS' Chicago Office from June, 1968 through January, 1972 (3-4). Investors inquired about bankline coverage of PENN CENTRAL in connection with purchases (23). With respect to issuers, investors also asked about total assets, current assets, current liabilities, net worth, total debt, net income, sales revenue, major depository banks, short-term borrowings, interim financial statements, bankline coverage, NCO rating, debt equity ratio, liquidity, working capital and cash position (25). NCO rating of prime was used as a selling tool (27). When PENN CENTRAL announced its first quarter (1970) losses, commercial paper salesmen were instructed to inform potential investors of PENN CENTRAL commercial paper of the earnings (91).

ROBERT L. HARRE

Commercial paper salesman in GOLDMAN, SACHS' St. Louis Office from October, 1968 through June, 1971 (3-7). Investor guidelines and inquiries regarding an issuer of commercial paper included NCO ratings, net worth, current assets and liabilities, earnings, long term debt, and bankline coverage and the nature of GOLDMAN, SACHS' credit investigation (49-54, 127). Prime meant NCO prime (74). HARRE would want to know NCO rating of an issuer if he were purchasing commercial paper (92).

ROBERT L. HOFFMAN

Credit analyst at GOLDMAN, SACHS from November, 1968 through fall, 1971 (3-4). Reported to FEKULA and VOGEL generally (4). He only discussed the review of the PENN CENTRAL 1969 financial statement written by HOFFMAN and commercial paper of PENN CENTRAL with VOGEL (6). HOFFMAN handled approximately 60 issuers during 1968 through 1970 (8). Initial credit review of GOLDMAN, SACHS consisted of reviewing issuer's financial statements and other public data (10). Credit analysts were instructed to make written reviews (14). Analyses of financial reports, Dun & Bradstreet Reports, Moodys and newspaper reports (14-15). PENN CENTRAL had poor earnings, high coverage of which VOGEL was aware (18). Continuing credit analysis subsequent to initial sales consisted of an annual review of subsequent financial statements, newspaper articles,

press releases, industry studies, Dun & Bradstreet reports, NCO reports and bank checkings (19-20). Frequency of review would vary depending on activity of the issuer (21). Credit analysts do not have regular contact with officers of an issuer (21). HOFFMAN did not participate in initial PENN CENTRAL credit investigation and became involved in late January or early February, 1970. HOFFMAN did nothing in connection with the continuing credit investigation of PENN CENTRAL other than prepare the review of the 1969 financial statements and read newspaper articles (23). No one else was responsible for the continuing credit investigation of PENN CENTRAL after late January, 1970 other than HOFFMAN (23). VOGEL never asked HOFFMAN to update PENN CENTRAL'S credit analysis (25). In January, 1970, PENN CENTRAL'S financial condition was worsening and profit basis was deteriorating (26). HOFFMAN never met with anyone of importance at PENN CENTRAL or discussed PENN CENTRAL with WEINBERG, LEVY, or WILSON (27). In connection with his credit analysis, HOFFMAN only looked at published data or information and made no further inquiries regarding encumbrances on PENN CENTRAL'S assets (29). A "goodly" portion of PENN CENTRAL'S assets were encumbered (30). Review of PENN CENTRAL'S 1969 financial statement by HOFFMAN was commenced in May, 1970 and done by HOFFMAN alone (32). HOFFMAN utilized financial statements, prospectuses, newspaper reports, Moody's published data and material in credit files but consulted no one in connection with the same (32). Preparation of review took about a week and was given to VOGEL (33). Analyzed PENN CENTRAL indentures and loan agreements but made no inquiry concerning and knew nothing about the liquidity of PENN CENTRAL investments (34). As of December 31, 1969, PENN CENTRAL had total assets of approximately $4.5 Billion of which $3 Billion were pledged and had current liabilities in excess of current assets (35). As of December 31, 1969, PENN CENTRAL had a net working capital deficit of $21 Million and $106 Million of debt due within one year (38). PENN CENTRAL required at least $227 Million in 1970 to meet short term obligations (39).

RAYMOND C. LEPLEY

Assistant Treasurer of PENN CENTRAL responsible for daily administration of commercial paper business with GOLDMAN, SACHS and in daily contact with GOLDMAN, SACHS (4). Dealt with DRYPOLCHER, LYNCH and VAN CLEAVE (5). At December 9, 1969 meeting between GOLDMAN, SACHS (VOGEL, VAN CLEAVE, DRYPOLCHER) and PENN CENTRAL (LODER, LEPLEY, VERLANDER) GOLDMAN, SACHS stated unhappiness with size of PENN CENTRAL inventory (7). Subsequent meeting among LEPLEY, LODER, O'HERRON and SCHAFFER in December, 1969 discussing the GOLDMAN, SACHS meeting (15). On December 23, 1969, PENN CENTRAL repurchased commercial paper from GOLDMAN, SACHS because GOLDMAN, SACHS was dissatisfied with the size of PENN CENTRAL'S commercial paper inventory (18, 21). The proceeds of the $50 Million debenture were used

to buy commercial paper of other issuers for PENN CENTRAL (19). All repurchases by PENN CENTRAL of PENN CENTRAL commercial paper from GOLDMAN, SACHS were at the request of GOLDMAN, SACHS (24). GOLDMAN, SACHS asked PENN CENTRAL to increase bankline coverage in November and December, 1969 because "investors in general look for commercial paper that had a 100% backup" (26). SCHAFFER and LEPLEY attempted to obtain additional banklines in the United States and in the Eurodollar market (27-28). PENN CENTRAL bought commercial paper through GOLDMAN, SACHS (31). In spring, 1970 approximately $96 Million of banklines were taken down (32). Two banks did not honor their bankline commitments (33). At the December 9, 1969 meeting, VAN CLEAVE said it was customary for issuers of GOLDMAN, SACHS to have 100% bankline coverage and that majority had 100% coverage (46). LEPLEY confirmed that because PENN CENTRAL did not have 100% bankline coverage it was sticking out like a sore thumb among GOLDMAN, SACHS' customers (49-50). It would be difficult and expensive for PENN CENTRAL to obtain 100% bankline coverage because of the bad credit market and the fact that PENN CENTRAL was heavily borrowed from domestic banks (51-52, 55, 100). He does not recall if GOLDMAN, SACHS updated its credit investigation in November or December, 1969 (58). He does not know anything which GOLDMAN, SACHS did in 1970 to update its credit investigation (63). LEPLEY purchased commercial paper for PENN CENTRAL subsidiaries from GOLDMAN, SACHS from December, 1969 through June, 1970 (74). GOLDMAN, SACHS never requested any financial information from LEPLEY (94).

ROGER M. LYNCH

Commercial paper salesman at GOLDMAN, SACHS from 1966 through 1967 and a commercial paper buyer at GOLDMAN, SACHS from 1968-1970 (3-4). In 1969/1970, GOLDMAN, SACHS handled approximately 250 to 300 commercial paper issuers (9). No limit existed regarding amount of commercial paper which could be purchased from an individual issuer although an overall limit existed (19). Eight to ten percent of outstandings is not necessarily an excessive inventory (21). He was never instructed to obtain credit information from PENN CENTRAL (29). WILSON advised him of a $5 Million inventory limit on PENN CENTRAL in 1970 (39). He does not recall an inventory limit ever being placed on any issuer other than PENN CENTRAL (41). He discussed competitive rates with VERLANDER so GOLDMAN, SACHS could retain and get business of PENN CENTRAL (62). He never inquired with respect to the encumbrances of PENN CENTRAL assets, PENN CENTRAL'S liquidity situation or financing plans (68). GOLDMAN, SACHS never bought PENN CENTRAL commercial paper as an agent (110).

JOHN O'HERRON

A. April 26, 1973 Deposition

PENN CENTRAL Vice President of Finance (4). He reported to BEVAN (4). $50 Million of $300 Million revolver or revolving credit (secured by stock of the PENNSYLVANIA COMPANY) was utilized for backup of commercial paper (21-22). PENN CENTRAL had $50 Million in additional banklines outside the revolver which was committed to commercial paper (24-25). As of September, 1969, PENN CENTRAL had $100 Million in banklines for $150 Million of commercial paper (29). He told WILSON that PENN CENTRAL had a large amount of credit and preferred not to increase credit, or that probability of increasing credit was small (30). PENN CENTRAL was close to legal lending limits of most banks (35). In September, 1969, PENN CENTRAL operated at a deficit cash flow, was losing money and had deficit net earnings (43-45). Probability of PENN CENTRAL borrowing long term money in September, 1969 was low (46). He does not recall if GOLDMAN, SACHS inquired about the $4.5 Billion of PENN CENTRAL assets which were pledged or mortgaged (50). PENN CENTRAL was always in a tight cash position (51). PENN CENTRAL had a significant continuing cash deficit in excess of $200 Million (57-59). He had no in depth discussion with GOLDMAN, SACHS concerning PENN CENTRAL financial alternatives or programs (66). He told GOLDMAN, SACHS that PENN CENTRAL would be in a tight cash position in the first quarter of 1970 but GOLDMAN, SACHS did not inquire into the reasons and no in depth discussion regarding the same occurred (67). He does not recall if GOLDMAN, SACHS requested cash flow statements showing gains and losses (70). He spoke with WILSON once or twice a month and others at GOLDMAN, SACHS less frequently (73-74). PENN CENTRAL had a loss in third quarter of 1969 and its earnings were substantially down (76). The ICC approved the $50 Million commercial paper increase for PENN CENTRAL on or about November 7, 1969 (87). After adverse articles about PENN CENTRAL in December, 1969, WILSON had no recollection of GOLDMAN, SACHS requesting further information or cash flow statements (92). GOLDMAN, SACHS was concerned about the amount of PENN CENTRAL inventory it held (99). He does not recall if GOLDMAN, SACHS inquired about PENN CENTRAL passing a dividend in fall, 1969 (102). He had no recollection of GOLDMAN, SACHS requesting fourth quarter, 1969 PENN CENTRAL budgets or discussing same with GOLDMAN, SACHS (124). No recollection of GOLDMAN, SACHS requesting or PENN CENTRAL giving GOLDMAN, SACHS PENN CENTRAL agreements in connection with PENN CENTRAL'S pledging of assets.

B. May 8, 1973 Deposition

At the September, 1969 meeting with GOLDMAN, SACHS, GOLDMAN, SACHS was told that the third quarter, 1969 loss would be small and the fourth quarter would be in the black

with good improvement (19). GOLDMAN, SACHS raised the issue about the level of PENN CENTRAL'S inventory more than once in 1969 and 1970 (23). At the February 6, 1970 luncheon meeting between GOLDMAN, SACHS and PENN CENTRAL, BEVAN presented PENN CENTRAL'S 1970 outlook (26). When GOLDMAN, SACHS wanted additional banklines for PENN CENTRAL, PENN CENTRAL resisted obtaining the same (31). At the February 6, 1970 luncheon meeting BEVAN said PENN CENTRAL'S cash deficit would be less in 1970 (30). He had frequent discussions with GOLDMAN, SACHS that GOLDMAN, SACHS was unable to maintain $200 Million of PENN CENTRAL commercial paper outstandings unless PENN CENTRAL increased its banklines (43). PENN CENTRAL met with First National City Bank, Chemical Bank, Irving Trust Co. and Mellon National Bank on or about February 5, 1970 (42), probably prior to luncheon meeting (46). PENN CENTRAL was reluctant to obtain additional banklines (47-49). From fall, 1969 through June 1970, PENN CENTRAL was in a tight cash position, had liquidity problems, had a significant position of its assets encumbered, had a frequent deficit working capital position, had a declining equity, short term debt was increasing, and was in a poor financial condition (85-90). Aside from PENN CENTRAL'S commercial paper business, GOLDMAN, SACHS was an underwriter in connection with PENN CENTRAL obligations and was involved in trust investment activities of PENN CENTRAL (93). GOLDMAN, SACHS (WILSON) rendered an opinion to PENN CENTRAL in connection with its application to the ICC to increase outstanding commercial paper from $150 Million to $200 Million (96-97). Prior to the public release of information, PENN CENTRAL gave GOLDMAN, SACHS estimates or comments on earnings in confidence (102). He never recalled GOLDMAN, SACHS requesting information from PENN CENTRAL and not furnishing the same to GOLDMAN, SACHS (150). Except for equipment financing, PENN CENTRAL relied entirely on short term financing after 1969 (151-152). On December 24, 1969, PENN CENTRAL bought $16 Million of PENN CENTRAL commercial paper from GOLDMAN, SACHS' inventory (154). GOLDMAN, SACHS frequently raised the issue of PENN CENTRAL obtaining additional banklines (177). GOLDMAN, SACHS was given a copy of PENN CENTRAL'S application to the ICC to increase outstanding commercial paper from $150 to $200 Million. PENN CENTRAL purchased $10 Million of GOLDMAN, SACHS' inventory on or about February 9, 1970 by utilizing banklines and the amount of banklines was not thereafter increased by such amount (192-213). Ultimately, all banklines were utilized to meet maturing commercial paper (193). PENN CENTRAL provided GOLDMAN, SACHS all financial information requested by GOLDMAN, SACHS from September, 1969 through June, 1970 (208-209).

WILLIAM C. STUTT

Vice-President of Corporate Finance for GOLDMAN, SACHS (3). Solicited new business from old and new clients (4).

GOLDMAN, SACHS is the largest commercial paper dealer and could provide financial information about issuers (13). Commercial paper is a quality short term investment (13). GOLDMAN, SACHS had more selection of issuers than anyone else because of its size (14). He had no contact with PENN CENTRAL (20). Safety or security of principal of commercial paper is important to investors (35). Some investors were interested in bankline coverage, NCO ratings, balance sheet, income statement, debt-equity ratio of issuer and whether commercial paper was a prime name (37-38). Safety of the issuer is an important consideration (49-52).

MATTHEW TOLAN

National sales manager of GOLDMAN, SACHS' commercial paper department from May, 1969 through January, 1971 (3). He supervises and analyzes commercial paper department of GOLDMAN, SACHS and reports to WILSON and VAN CLEAVE (4). Some investors only buy NCO prime commercial paper. The "Blue Book" was written for the management committee in 1969 by WILSON, VAN CLEAVE, LYNCH, TOLAN and WEINBERG (14). It was submitted to the management committee in early 1970 (16). Investors commonly ask for NCO rating and many have the investing criterion of an NCO prime rating (21-21). He recommended that GOLDMAN, SACHS' commercial paper department incorporate to minimize its risk but if GOLDMAN, SACHS carried no inventory it would be unnecessary to incorporate (28-29). In April, 1970 salesmen were instructed to read first quarter earnings (1970) of PENN CENTRAL which was unusual procedure (32). In 1968 to 1970, investors were concerned with NCO ratings (41).

J. JERROLD TRIPI

Commercial paper salesman at GOLDMAN, SACHS beginning in April, 1967 (4). He told investors GOLDMAN, SACHS made a thorough credit investigation of issuer (27, 29-30). VAN CLEAVE, WILSON and TOLAN instructed salesmen to make a special effort to sell issuers in which PENN CENTRAL had large inventory (32). NCO prime meant that the only rating agency for commercial paper had given the highest rating designation to the issuer (51). Prime meant an issuer had a net worth of $25 or $30 Million and had made a profit in the last 3 years (51). Investors inquired about an issuer's net worth and earnings (87). In 1970, he was instructed to read certain adverse information to investors (102, 106). He discussed GOLDMAN, SACHS' inventory position with investors (108).

JOHN L. WEINBERG

Partner and member of management committee at GOLDMAN, SACHS (3). He was responsible for the supervision of the commercial paper department and is the liaison between the commercial paper department and management committee (7). WILSON was the partner in charge of the commercial paper department and made decisions whereas WEINBERG had more general and long range duties (8). The management committee did not request a credit analysis of PENN CENTRAL or discuss PENN CENTRAL prior to June, 1970 (12-14). Prior to 1971, GOLDMAN, SACHS had no formal credit committee for periodic review of issuers (27). An important aspect of GOLDMAN, SACHS' commercial paper activity was aiding the corporate finance department in soliciting other investment banking business (36). GOLDMAN, SACHS was interested in obtaining PENN CENTRAL'S stock exchange business (38). GOLDMAN, SACHS held itself out as making a thorough credit analysis of an issuer before selling its commercial paper in market (41). GOLDMAN, SACHS represents commercial paper issuers have superior or high credit and one inducement of GOLDMAN, SACHS is that it offers quality commercial paper (48). The creditworthiness of PENN CENTRAL was never discussed at management committee meetings (57). The management committee never reviewed the procedures of the credit department (59). If he were buying commercial paper, he would want to know PENN CENTRAL was budgeting a $56 Million loss, that PENN CENTRAL said the cash picture would be very tight, that the cash position in the first quarter of 1970 would be tight, that PENN CENTRAL told GOLDMAN, SACHS that PENN CENTRAL could not obtain $100 Million in banklines and that BROWN BROS. had removed PENN CENTRAL from its approved lists (115, 116, 117, 126, 129). BROWN BROS. had a good reputation in the railroad banking field (128). It was an important judgment of GOLDMAN, SACHS to change to a best efforts against special order sales method (174-178). Access to credit or the ability to pay off loans is critical in connection with short term obligations (189). The inability to obtain additional banklines relates to access to credit (190).

JOHN C. WHITEHEAD

GOLDMAN, SACHS partner and member of the management committee in charge of the new business department (part of corporate finance) (3). The new business department is the marketing arm of GOLDMAN, SACHS (4). GOLDMAN, SACHS maintains a commercial paper inventory to serve issuers and investors by providing funds and alternative investments, respectively (10). It is difficult to compete with other commercial paper issuers if no inventory is maintained (12). Maintenance of inventory was an "effective competitive tool" (18) and an inducement to issuers to use GOLDMAN, SACHS as a dealer (19-20). Commercial paper business was used as an entree by the commercial paper issuer (24).

APPENDIX B - DECISION OF JUDGE METZNER
IN FRANKLIN v. LEVY

APPENDIX B

1417a

(081)

ITED STATES DISTRICT COURT
UTHERN DISTRICT OF NEW YORK

YIN SAVINGS BANK IN THE
W YORK,

Plaintiff,

-against-

STAVE L. LEVY, HENRY B. POHLER, JAMES C. HEMPHILL, EDWARD A. SCHRADER, STANLEY R. MILLER, JOHN L. WEINBERG, JOHN C. WHITEHEAD, CHARLES E. SALTZMAN, HOWARD R. YOUNG, ARTHUR G. ALTSCHUL, CHARLES L. GRAESER, JAMES D. ROBERTSON, L. JAY TENENBAUM, ROBERT S. DANFORTH, RICHARD J. FAY, H. FREDERICK KRIMENDAHL, II, GEORGE E. DOTY, DONALD R. GANT, JAMES P. GORTER, PETER A. HAGER, LEWIS J. KAUFMAN, JAMES S. MARCUS, ALAN L. EWELL, J. FRED WELNTZ, JR., ROBERT B. MENSCHEL, ROBERT E. MNUCHIN, SIDNEY J. WEINBERG, JR., LEWIS H. WESTON, ROBERT G. WILSON, PETER A. LEVY, L. THOMAS KELLY, THOMAS B. WALKER, JR., GEORGE T. BOWER, MICHAEL H. COLES, JOHN C. JAMISON, RICHARD L. MENSCHEL, ROSS E. TRAPHAGEN, JR., ROBERT B. ANDERSON, JR., WALTER P. BARLIE, JOHN W. CALLAGHAN, WALTER J. CREELY, MILES J. CRUICKSHANK, ROBERT V. GORDON, RICHARD P. OAKLEY, JOHN H. RHOADES, EDITH L. SACHS as Trustee of the trust for the benefit of Howard J. Sachs under the Last Will and Testament of Harry Sachs, WALTER E. SACHS, individually and as Trustee of the trust for the benefit of Walter E. Sachs under the Last Will and Testament of Samuel Sachs, and HAROLD S. GASS, individually and doing business under the firm name and style of GOLDMAN, SACHS & CO.,

Defendants.

FILED
DEC 29 1975
S. D. OF N. Y.

#43613

71 Civ. 362
(CBH)

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1418a (1087)

NITED STATES DISTRICT COURT
OUTHERN DISTRICT OF NEW YORK

'KIN SAVINGS BANK IN THE
W YORK,

Plaintiff,

-against-

TAVE L. LEVY, HENRY H. FOWLER,
MES C. HEMPHILL, EDWARD A.
SCHRADER, STANLEY R. MILLER, JOHN L.
WEINBERG, JOHN C. WHITEHEAD, CHARLES
E. SALTZMAN, HOWARD R. YOUNG, ARTHUR
G. ALTSCHUL, CHARLES L. GRANKIN,
JAMES D. ROBERTSON, L. JAY TENENBAUM,
ROBERT S. DAMFORTH, RICHARD J. FAY,
H. FREDERICK KRIMENDAHL, II, GEORGE
E. DOTY, DONALD R. GANT, JAMES P.
GORTER, PETER A. HAGER, LEWIS J.
KAUFMAN, JAMES S. MARCUS, ALAN L.
STEIN, J. FRED WEINTZ, JR., ROBERT
B. MENSCHEL, ROBERT E. MENSCHIN, SIDNEY
J. WEINBERG, JR., LEWIS M. WESTON,
ROBERT G. WILSON, PETER A. LEVY,
L. THOMAS KELLY, THOMAS B. WALKER, JR.,
GEORGE T. BOWER, MICHAEL H. COLES,
JOHN C. JAMISON, RICHARD L. MENSCHEL,
ROSS E. TRAPHAGEN, JR., ROBERT P.
ANDERSON, JR., WALTER F. BLAINE,
JOHN W. CALLAGHAN, WALTER J. CREELY,
MILES J. CRUICKSHANK, ROBERT V. HORTON,
RICHARD P. OAKLEY, JOHN H. MEADES,
EDITH L. SACHS as Trustee of the trust
for the benefit of Howard J. Sachs under
the Last Will and Testament of Harry
Sachs, WALTER E. SACHS, individually
and as Trustee of the trust for the
benefit of Walter L. Sachs under the
Last Will and Testament of Samuel Sachs,
and HAROLD S. WASS, individually and
doing business under the firm name and
style of GOLDMAN, SACHS & CO.,

Defendants.

DEC 29 1975
S. D. OF N. Y.

#43613

71 Civ. 3[illegible]
(CMM)

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Of Counsel

METZNER, D. J.:

Franklin Savings Bank (Franklin) filed this action against the general partners of Goldman, Sachs & Company (Goldman, Sachs), alleging violations of Sections12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 771(2), 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), the New York Martin Act, N.Y. General Business Law § 352(c), and the common law.

Goldman, Sachs is engaged in the business of investment banking, underwriting and dealing in securities. It has achieved a reputation as one of the leaders in this field. One of the areas of its activity is as a dealer in commercial paper. As used here, commercial paper is the unsecured promissory notes of well-known large financial or industrial corporations, with a maturity of less than 270 days. Goldman, Sachs held itself out as the oldest and leading commercial paper dealer in the country. It was the exclusive dealer for the sale of Penn Central Transportation Company (PCTC) commercial paper, as well as for 225 other corporations. As a dealer, it purchased the notes of an issuer for resale as principal, and held the

notes in inventory just as a retailer holds stock-in-trade in inventory.

In 1968, the State of New York enacted a statute (N.Y. Banking Law § 235(12-a) (McKinney 1971)), which allowed savings banks to invest in commercial paper. The purpose of the statute was to widen the investment opportunities available to these banks to include low risk and higher interest-paying securities. In order to qualify for purchase by the bank, the paper first had to receive a prime ("the highest") rating from an independent rating service designated by the state banking board. The National Credit Office, a subsidiary of Dun & Bradstreet, Inc., was so designated.

Immediately after the adoption of this law, Goldman, Sachs wrote to the plaintiff requesting the opportunity to make a presentation of the services it could render in the purchase of commercial paper. Subsequently, purchases of such paper, issued by various companies, were made by Franklin from Goldman, Sachs.

On March 16, 1970, Harry H. Lock, plaintiff's president, called Goldman, Sachs and said that he was interested in buying 30-day commercial paper totalling

$1,500,000. Goldman, Sachs offered a $1,000,000 note of the Thomas J. Lipton Company, and a $500,000 note of PCTC. Plaintiff bought both notes.

I should point out here that the Penn Central Company is a holding company whose stock was publicly owned. Penn Central owned all the stock of PCTC.

The PCTC note matured on June 30, 1970, but unfortunately, on June 21, 1970, the Penn Central System of companies, which included PCTC, filed for reorganization under the Bankruptcy Act. The note was duly tendered but payment was never received. Hence this lawsuit for damages and rescission of the sale.

The issues were developed during a nine-day trial to the court without a jury. Defendants challenge both the jurisdiction of the court and the merits of plaintiff's claim.

1. Jurisdictional Basis under Section 12(2) of the 1933 Act

Section 12(2) provides for the liability of the seller of a security under certain conditions provided that the security was offered or sold "by the use of any means or instruments of transportation or communication in interstate commerce or of the mails . . . ."

Goldman, Sachs contends that there was no use of an interstate instrumentality or the mails sufficient to give jurisdiction under the 1933 Act.

The interstate telephone calls proved by plaintiff relate solely to the purchase of the note by Goldman, Sachs, as a principal, from PCTC, or to setting general sales policy. They do not involve a use of interstate facilities in connection with the sale by defendants, as principal, to this plaintiff. III L. Loss, Securities Regulation, ch. 11C at 1708 (2d ed. 1961).

The only telephone calls directly involved with the sale of this note were intrastate calls. These are insufficient for jurisdiction under the 1933 Act although sufficient under the Securities Exchange Act of 1934. United States v. De Sapio, 299 F. Supp. 436 (S.D.N.Y. 1969). See Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).

The sale in this case consisted primarily of delivery of the note and receipt of payment. Admittedly, neither of these acts was accomplished by the use of the mails. Plaintiff, after placing the purchase order, directed its agent bank, Savings Bank Trust Company, to

furnish funds to Chemical Bank to pay for the purchase. The note was to be held by Chemical solely as a depository. Defendants hand-delivered the note with a confirmation slip attached to Chemical against payment in federal funds. The use of federal funds is in effect payment in cash. However, this does not end the inquiry since use of the mails after the time of the primary acts may still affect the transaction in order to bring Section 12(2) into operation.

Plaintiff relies mainly on the mailing of a confirmation slip by defendants to plaintiff after completion of the transaction. United States v. Cashin, 281 F.2d 669 (2d Cir. 1960). Defendants seek to distinguish Cashin by relying on the fact that the usual form of confirmation slip or "sales bill" was attached to the note when it was delivered to Chemical Bank, and thus the mailing was superfluous. That slip contained the discount date, the name of the purchaser, the face amount of the note, the discount rate and amount, the maturity date of the note, the net discounted price, and delivery instructions. All of this is important information since the note only revealed its face value and maturity date.

The slip was a necessary document not only for the internal records of Franklin, but for the auditors of the New York State Banking Department.

Assuming that the sales slip was a confirmation slip, it is effective for its intended purpose only if it reaches the purchaser. Delivery to Chemical Bank as custodian of the note did not achieve this goal. The information still had to reach plaintiff, and that occurred here when Savings Bank Trust Company mailed the advice to Franklin. Such use of the mails was reasonably foreseeable by defendants. United States v. Weldon, 404 F.2d 779 (2d Cir. 1968), cert. denied, 394 U.S. 946 (1969); III Loss, supra, ch. 9F at 1531-36, and VI Loss, supra, ch. 9J at 3744-51. Thus, either the mailing by Savings Bank Trust Company or the mailing by Goldman, Sachs provides the jurisdictional base for the remedy provided by Section 12(2).

2. Jurisdictional Basis under Section 10(b) of the 1934 Act

The applicability of the anti-fraud provisions of Section 10(b) of the 1934 Act depends on whether this note is a security. Section 3(a)(10) of that Act states

in pertinent part:

> "(10) The term 'security' means any note . . . but shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." (Emphasis added.)

The note in question matured in less than nine months, but that does not end the matter. There is still the question of whether the note is of a certain type of commercial paper. Zeller v. Bogue Electric Manufacturing Corporation, 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973); Sanders v. John Nuveen & Company, 463 F.2d 1075 (7th Cir.), cert. denied, 409 U.S. 1009 (1972). In Zeller the court agreed with the decision in Sanders that despite the wording of the exemption, a promissory note with a maturity of less than nine months may still be a security under the 1934 Act "unless the note fits the general notion of 'commercial paper' reflected in the SEC Release." Zeller, 476 F.2d at 800.

The Release referred to in Zeller is 33-4412, 17 C.F.R. § 231.4412. That Release, which dealt with the exemption of a security from the registration requirements of the 1933 Act, stated:

> "The legislative history of the Act makes clear that section 3(a)(3) [of the 1933 Act] applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks." 26 Fed. Reg. 9159 (Sept. 29, 1961).

Zeller holds that there is no doubt that the SEC would take the same view with respect to the exclusion provided in Section 3(a)(10) of the 1934 Act.

The record shows that these notes were issued usually in amounts of at least $500,000, with many over the million dollar mark. The record further shows that the purchasers, except in one or two instances, appear to be banks or large corporations seeking short-term investment for excess cash. Neither type of purchaser fits the definition of "general public" as used in the SEC Release, nor in the legislative history referred to in that Release. For example, the Senate Report states:

> "It is not intended under the bill to require the registration of short-term commercial paper which, as is the usual practice, is made to mature in a few months and ordinarily is not advertised for sale to the general public." S. Rep. No. 47 on S. 875, 73d Cong. 1st Sess. (1933) at 4.

Franklin urges that since PCTC notes were admittedly being "rolled over," that is, sold to cover maturities coming due, they were not being issued to facilitate current operational business requirements. However, in Release 33-4412, the SEC's position is clear that such "roll over" notes are exempt if the original indebtedness is exempt under Section 3(a)(3). Accordingly, the mere fact of roll over, where there is no provision in the note that it be automatic, does not remove the exemption.

As to the requirement that the note be of a type eligible for discount by the Federal Reserve banks, 12 C.F.R. § 201.4(a) adopts the current transactions standard. That standard is met so long as the initial use of the proceeds was for proper purposes. Plaintiff has failed to show that the original use of the PCTC commercial paper was not for the current operating purposes required by the SEC test.

However, the fact that the notes, when originally issued, were prime quality and thus initially exempt, does not mean that the "roll overs" were prime at the

time of issuance. Intervening events may change the picture.

When evaluating the quality of this commercial paper, it must be borne in mind that we are looking at the transaction as of March 16, 1970, and not the date of reorganization 3-1/2 months later. The court is not justified in making the assumption that simply because reorganization occurred in the middle of June, this commercial paper was not properly sold as prime by Goldman, Sachs in March.

Goldman, Sachs relies on the prime rating given this paper by the National Credit Office in the exercise of its statutory function. The only trouble with Goldman, Sachs' position is that the rating organization appears to have continued the prime rating on February 5 in reliance on defendants' decision to continue to sell this paper despite adverse news as to the financial condition of Penn Central. Franklin could only buy notes rated high by NCO, but such rating does not absolve Goldman, Sachs of its duty of disclosure. The question is whether Goldman, Sachs' decision under all the circumstances was proper in view of the protections afforded investors by the securities laws.

Defendants also rely on the Interstate Commerce Commission's report, after a full investigation, approving the increase from $150 million to $200 million in the amount of commercial paper that the Penn Central could have at any one time. It noted that the issuer was in a strong financial condition. However, this approval was issued in October 1969, too remote in time to be relied on in this case. We are talking about six months later in what appears to have been fast-moving events in Penn Central's financial picture. Furthermore, the permission was predicated on Penn Central's representation that it would obtain long-term financing as soon as the tight money market eased.

I find, for the reasons fully explained below in discussing the merits of the litigation, that this note bought by Franklin on March 16, 1970, was not prime commercial paper at the time of purchase, and was not exempt from the provisions of Section 10(b).

3. Plaintiff's Standing under Section 17(a) of the 1933 Act

This section provides remedies for fraud even though the securities are exempt from registration under the 1933 Act.

Since the plaintiff has a right of action under Section 10(b), it is unnecessary to join the battle as to whether a private right of action for damages is one of the remedies afforded by Section 17(a). The basis for relief is the same under both sections. E.g., Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969). For those interested, Judge Gignoux has fully discussed the respective contentions in Dyer v. Eastern Trust and Banking Company, 336 F. Supp. 890 (D. Maine 1971).

4. The Merits of this Litigation

There is no doubt that everyone expected Penn Central initially to be in a tight financial situation following the merger of the two major railroad systems in February 1968. Time was necessary to achieve the economies envisaged by the plan. It would even be necessary to make extraordinary expenditures in the beginning to achieve long-term savings. However, the merged company enjoyed a high credit rating and was able to issue and sell commercial paper because of the usual indicia of good management, past earnings, cash

flow, and being a large enterprise exhibiting leadership in the industry.

Problems arose, however, which created cash requirements beyond those envisioned by the knowledgeable people. The report of the ICC in October 1969 approving the raising of the limit to $200 million of commercial paper that Penn Central could issue was out of date with the picture as it existed in the early part of 1970.

Penn Central's financial statement for the year 1969 and the fourth quarter of that year was announced on the broad tape of the New York Stock Exchange on Wednesday, February 4, 1970, and was carried in the press the next day. The loss for the year was $56.3 million or ten times greater than the 1968 loss. The loss for the fourth quarter was $13.2 million. The fourth quarter was supposed to show a profit and the loss shocked the people at Goldman, Sachs into immediate action. They conferred among themselves the night of February 4 and on February 5. They arranged a luncheon conference with the Penn Central people for Friday, February 6.

In addition, on February 5, defendant Wilson talked to O'Herron, financial vice president of Penn Central, about the bad news. Wilson said that "it was unfortunate that we did not have some indication of the magnitude of the total losses for 1969, as we are going to need a story to tell existing holders of Penn Central's paper and new purchasers of paper." While Wilson indicated that Goldman, Sachs would continue to offer this paper, including the $15-odd million that Goldman, Sachs had in its inventory, he did explore the possibility of Penn Central's buying back this inventory out of bank credit lines then available to it. O'Herron agreed to buy back $10 million worth on the following Monday, February 9.

The luncheon on February 6 was attended by defendants Levy and Wilson representing Goldman, Sachs, Bevan, executive vice president of Penn Central, Loder, its treasurer, and O'Herron. The Penn Central people said there would be a budgeted loss for PCTC of $56 million for the year 1970, which, when added to $170 million of additional necessary financing, resulted in a requirement of $226 million in cash for that year. $70 million already had been arranged for. They would

attempt a $100 million bond sale later on, but in the meantime, would seek a $70 million "bridge" loan to tide them over. In fact, this loan was obtained well before the purchase of the note by plaintiff.

For some time Goldman, Sachs had been urging Penn Central to obtain additional bank lines of credit to cover its outstanding commercial paper of $200 million. Penn Central had only $100 million of back up credit. The Penn Central people again were told that they had to obtain $100 million more in bank lines of credit so as to have 100 per cent line coverage. This was necessary to keep its $200 million of paper outstanding. Otherwise it was perfectly possible that roll overs would not be successful and the total outstanding commercial paper could run down to $100 to $150 million.

Finally, Levy and Wilson told the Penn Central people at the luncheon that Goldman, Sachs would place a limit of $5 million on the paper of Penn Central which it would carry in inventory. The inventory had been running up to $20 million. On February 9, Penn Central bought back $10 million of its paper, reducing the inventory to just below the $5 million level.

Some explanations have been offered by Goldman, Sachs for the decision to reduce inventory. The first is that there would be a drop in demand for the commercial paper with the publication of the 1969 audited financial statements and consequently, there would be no need for carrying such a large inventory. February 6 was a Friday and the $10 million in inventory was bought back by Penn Central on the following Monday, without any experience as to whether the paper could be sold or not. It turns out that the sales stood up extremely well for some time thereafter and reducing inventory through a buy-back did not seem to have been necessary.

The second reason given for the reduction in inventory is the so-called "negative inventory carry." Goldman, Sachs is not a bank and has to finance its purchases of commercial paper by borrowings. It is claimed that the interest charges at this time of tight money ran higher than the return on commercial paper. Consequently, the business was unprofitable. However, it appears that only the inventory of Penn Central paper was reduced by asking the issuer to buy back. No other inventories were reduced by Goldman, Sachs in this manner.

Finally, it should be pointed out that while Goldman, Sachs was of the opinion that there was insufficient bank lines of credit for the outstanding commercial paper, it knew that the $10 million buy-back was being financed by Penn Central out of its precious existing insufficient lines of credit.

It is the surrounding circumstances involved in the buy-back, and the removal of Penn Central commercial paper from Brown Brothers Harriman's approved list on February 5, which creates the problem in this case. Brown Brothers Harriman had held as much as 15 per cent of the total outstanding paper of Penn Central through purchases from Goldman, Sachs. The action by Brown Brothers Harriman was a subject of discussion at the February 6 luncheon.

It is an inescapable conclusion that starting with February 4, Goldman, Sachs just did not have faith in this paper any more and was lightening its load and reducing its exposure. At this point I find that the paper could no longer be considered prime paper and qualify for exemption from the provisions of Section 10(b).

If investors knew that Goldman, Sachs had

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arranged for buy-backs by Penn Central of $10 million of its inventory, and that Brown Brothers Harriman had stopped buying at all, there is no doubt in my mind that there would be no chance of ever selling this paper as roll overs for maturing paper. The "run down" of outstanding paper would have been dramatic, and Penn Central would have been beating a trail to the courthouse steps three months sooner than it did.

Goldman Sachs furnished its customers with three types of information contained in "white," "green," and "yellow" sheets as part of its recognized duty to disclose material information to its customers. Such sheets were mailed to Franklin. The "white" sheets contained audited financial statements of the issuer, the "yellow" sheets described the business of the issuer, and high-lighted some of the pertinent figures found in the "white" sheets. The "green" sheets contained credit information and other matters which may be of importance to the purchaser of the commercial paper. None of the "green" sheets issued after February 6 up to March 16 gave any inkling of the course of conduct pursued by Goldman, Sachs in relation to Penn Central's commercial paper.

Mr. Bock, president of Franklin, purchased this note without question immediately upon its being offered. He purchased a similar note several days before in the same fashion. He was possessed of extensive financial background and experience, including having been a security analyst for a leading stock exchange firm here in New York. He was aware of and used all available financial information in evaluating investments. He knew of the Penn Central's poor financial report for the year 1969, yet he never asked Goldman, Sachs why he should buy Penn Central paper in view of what that report showed. He was not interested in bank lines of credit to back up the outstanding commercial paper. He knew or should have known that a footnote to the 1969 financial statement pointed out that substantially all assets had been pledged as security for loans.

Despite this lack of ordinary prudence, which would be expected of a person with his background, he testified that if he had known the unreported facts outlined above, he would not have bought the paper. The issue then is whether Goldman, Sachs was under a duty to divulge the information, and I hold it was.

I understand the reluctance of Goldman, Sachs possibly to be the cause of such calamity to our economic structure. In addition, it had close business, if not personal ties, to the Penn Central management which would be jeopardized in the event of collapse. However, it is disclosure of just such information in the circumstances, such standard of fair dealing, such requirement of truth to which the anti-fraud sections of the securities laws are directed. This is the perfect example of an omission "to state a material fact necessary to make the statement made, in light of the circumstances under which they were made, not misleading."

When Goldman, Sachs sold this paper, it was understood that it was holding out the paper as credit-worthy and high quality. The information which it failed to disclose was clearly material since "a reasonable man would attach importance [to it] in determining his choice of action in the transaction . . . ," List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). Under the circumstances, Goldman, Sachs "must either disclose it to the investing public, or, if [it] is disabled from disclosing it in order to

protect a corporate confidence, or [it] chooses not to do so, must abstain from trading in or recommending the securities concerned . . . ." Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir.), cert. denied sub nom. Coates v. Securities and Exchange Commission, 394 U.S. 976 (1968).

The Court held in Affiliated Ute Citizens v. United States, 406 U.S. 128,154 (1972), that: "This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." There need be no reliance by plaintiff to sustain recovery for nondisclosure under Section 10(b). Competitive Associates, Inc. V. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811 (2d Cir. 1975); Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970).

Having decided to sell the notes without disclosing these material facts, Goldman, Sachs is liable to the plaintiff for violation of Section 10(b).

In view of the understanding between the parties as to the basis upon which the notes were being sold, which amounts to a statement of a material fact, Goldman, Sachs is also liable under Section 12(2).

Plaintiff has failed in its extensive post-trial briefs to treat either the common law action for fraud or the claim for relief under the Martin Act. I can only assume that they are not being pressed and therefore they are dismissed.

It is unnecessary for the court to rule on the huge number of objections to deposition testimony that was offered in evidence. None of the proffered evidence to which objection was made has been relied upon by the court.

Judgment in the sum of $500,000, with interest and costs, shall be entered in favor of the plaintiff.

So ordered.

Dated: New York, N. Y.
December 24, 1975

Charles H. Tenney
U. S. D. J.

APPENDIX C - NEW YORK GENERAL BUSINESS LAW §352-C

APPENDIX C

New York General Business Law §352-c provides:

"1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices:

(a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale;

(b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;

(c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made;

where engaged in to induce or promote issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities, as defined in section three hundred fifty-two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.

2. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to engage in any artifice, agreement, device or scheme to obtain money, profit or property by any of the means prohibited by this section.

3. A person, partnership, corporation, company, trust or association, or any agent or employee thereof, using or employing any act or practice declared to be illegal and prohibited by this section, shall be guilty of a misdemeanor."

APPENDIX D - CALIFORNIA CORPORATIONS CODE §§24501 and 25501

APPENDIX D

California Corporations Code §§24501 and 25501 provide:

"§25401. Sale or purchase of securities by means of written or oral communications containing false statements or omissions

It is unlawful for any person to offer or sell a security in this state or buy or offer to buy a security in this state by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

"§25501. Violation of section 25401; suit for recission or damages; defense

Any person who violates Section 25401 shall be liable to the person who purchases a security from him or sells a security to him, who may sue either for recission or for damages (if the plaintiff or the defendant, as the case may be, no longer owns the security), unless the defendant proves that the plaintiff knew the facts concerning the untruth or omission or that the defendant exercised reasonable care and did not know (or if he had exercised reasonable care would not have known) of the untruth or omission. Upon recission, a purchaser may recover the consideration paid for the security, plus interest at the legal rate, less the amount of any income received on the security, upon tender of the security. Upon recission, a seller may recover the security, upon tender of the consideration paid for the security plus interest at the legal rate, less the amount of any income received by the defendant on the security. Damages recoverable under this section by a purchaser shall be an amount equal to the difference between (a) the price at which the security was bought plus interest at the legal rate from the date of purchase and (b) the value of the security at the time it was disposed of by the plaintiff plus the amount of any income received on the security by the plaintiff. Damages recoverable under this section by a seller shall be an amount equal to the difference between (1) the value of the security at the time of the filing of the complaint plus the amount of any income received by the defendant on the security and (2) the price at which the security was sold plus interest at the legal rate from the date of sale. Any tender specified in this section may be made at any time before entry of judgment."

APPENDIX E - CALIFORNIA CORPORATIONS CODE §§25402 and 25502

APPENDIX E

California Corporations Code §§25402 and 25502 provide:

"§25402. Purchase or sale of securities by persons having access to material information not available to public through special relationship with issuer

It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information."

"§25502. Violation of section 25402; damages

Any person who violates Section 25402 shall be liable to the person who purchases a security from him or sells a security to him, for damages equal to the difference between the price at which such security was purchased or sold and the market value which such security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information, plus interest at the legal rate, unless the defendant proves that the plaintiff knew the information or that the plaintiff would have purchased or sold at the same price even if the information had been revealed to him."

Defendant's Post-Trial Memorandum

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

- x

UNIVERSITY HILL FOUNDATION, :

Plaintiff, : 71 Civ. 1166 (MEL)

-against- :

GOLDMAN, SACHS & CO., :

Defendant. :

- x

DEFENDANT'S POST-TRIAL MEMORANDUM

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APPENDIX B - SUMMARY OF DEPOSITION TESTIMONY B-1

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

UNIVERSITY HILL FOUNDATION,	:	
Plaintiff,	:	71 Civ. 1166 (MEL)
-against-	:	
GOLDMAN, SACHS & CO.,	:	
Defendant.	:	

DEFENDANT'S POST-TRIAL MEMORANDUM

INTRODUCTION

The extraordinarily voluminous documentation of each step in the history of Penn Central creates a risk that the essential issues in this case will be overlooked in a mass of irrelevant detail. Plaintiff's post-trial brief is eloquent testimony to the reality of that risk, occupying 171 pages of sound and fury, of which only a few pages are relevant. Defendant submits that Judge Metzner was correct at least in recognizing that the real issue here is Goldman, Sachs' good faith: If the steps taken and not taken in connection with the sale of Penn Central commercial paper were

done honestly and in the good faith belief that Penn Central continued to be a viable company, no liability to this plaintiff should be imposed under the federal securities laws. If the acts taken or not taken by Goldman, Sachs were caused by a fear or conviction that Penn Central was a likely candidate for the reorganization courts and that Goldman, Sachs should protect itself at the expense of its clients, a judgment in favor of plaintiff would be appropriate.

The length of this brief is mainly the result of a necessarily detailed analysis of the underlying bases for Goldman, Sachs' good faith judgment. The evidence marshalled hereafter demonstrates the reasonableness of the belief that Penn Central continued to be a viable company, the immaterial nature of those few discrete items of information not readily available to plaintiff, the lack of any causal relationship between plaintiff's purchase and any statement or omission by Goldman, Sachs and the business reasons why certain acts were taken by Goldman, Sachs which had nothing to do with any fear concerning the continued viability of Penn Central. Should the Court agree with our basic premise, namely that good faith is the only real issue involved here, it would not be necessary to review more than the first section of defendant's post-trial memorandum.

SUMMARY OF POSITION

Penn Central's commercial paper inventory at Goldman, Sachs was reduced in February 1970, although Goldman, Sachs thereafter maintained Penn Central inventory in varying amounts through the date of plaintiff's purchase. The witnesses who testified at trial explained why the reduction of Penn Central's inventory was the result of business considerations unrelated to any fear that Penn Central was not creditworthy. Judge Metzner unfortunately did not believe that testimony and concluded that the reduction of Penn Central inventory was caused by a fear that the Railroad would not survive. Plaintiff has urged this Court to give estoppel effect to that finding which, if done, would necessarily result in a judgment for plaintiff. Point I of this memorandum will demonstrate the inappropriateness of collateral estoppel in the circumstances here present and will further show that, on the trial record in this case, this Court should conclude that Goldman, Sachs acted in good faith.

Point II will demonstrate that, in the circumstances under which plaintiff purchased commercial paper, there was demonstrable non-reliance on Goldman, Sachs sufficient to negative any finding of a causal connection between plaintiff's purchase and any statement or omission attributable to Goldman, Sachs. Further, we will show that, "in

light of the circumstances" of the commercial paper market, Goldman, Sachs was under no duty to communicate information to plaintiff and, accordingly, plaintiff cannot prevail.

Point III will review the credit analysis performed by Goldman, Sachs on the basis of which the Court should conclude that defendant had a reasonable basis for its judgment that Penn Central continued to be creditworthy at the date of plaintiff's purchase.

Finally, Point IV will review each of the particular items of information claimed to constitute material omissions. Even assuming for purposes of argument that such information was causally related to plaintiff's purchase, it will be shown that it was either publicly available or immaterial in the light of publicly available information.

I. GOLDMAN, SACHS ACTED IN GOOD FAITH IN OFFERING THE COMMERCIAL PAPER OF PENN CENTRAL.

Plaintiff challenges Goldman, Sachs' good faith and integrity in offering Penn Central commercial paper, arguing that the reduction of Goldman, Sachs' inventory of Penn Central paper was motivated by a desire to reduce the risk of loss due to the foreseeable collapse of the Railroad. Plaintiff also urges that this Court accept the determination by Judge Metzner in Franklin Savings Bank of New York v. Levy, CCH Fed. Sec. L. Rep. ¶ 95,389 (S.D.N.Y. Dec. 29, 1975), that Goldman, Sachs, in reducing its inventory of Penn Central paper, was reflecting its lack of faith in the continued viability of the Railroad. Plaintiff bases this argument on a claim of collateral estoppel. Neither contention has merit.

A. Collateral Estoppel is Inappropriate

Plaintiff recognizes the inherent inconsistency of arguing in a post-trial brief for a doctrine which is designed to protect against "relitigation". The issue which plaintiff urges as an estoppel was a determination made by the trier of fact in the Franklin case which turned on the credibility of Goldman, Sachs' witnesses. This Court heard those same witnesses, and heard additional evidence excluded from the Franklin trial, on the basis of which this Court can more

easily resolve the issue of Goldman, Sachs' good faith than it could the more hoary issue of the offensive use of non-mutual collateral estoppel. And it is precisely an issue such as credibility which has been recognized as particularly inappropriate for collateral estoppel.*

In this non-diversity case federal law of collateral estoppel applies. Heiser v. Woodruff, 327 U.S. 726, 733 (1946). That law was well formulated in the early case of Cromwell v. County of Sac, 94 U.S. 351, 353 (1876):

> "[W]here the second action between the same parties is upon a different claim or demand, the judgment in the prior action operates as an estoppel only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered. In all cases, therefore, where it is sought to apply the estoppel of a judgment rendered upon one cause of action to matters arising in a suit upon a different cause of action, the inquiry must always be as to the point

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* Defendant does not understand that plaintiff has invoked the doctrine of collateral estoppel with respect to any matter other than the question of Goldman, Sachs' supposed loss of faith in the creditworthiness of Penn Central. To the extent that plaintiff might seek to invoke the doctrine with respect to other facts, it is precluded by the individual variations which distinguish this case from Franklin. The role of Union Bank as an intervening cause, the reliance of Fitzpatrick upon LeMay to the exclusion of Goldman, Sachs, the sophistication and access to information of Union Bank as well as other factors discussed in part II, infra, all render inapplicable particular findings in Franklin based upon the characteristics of that plaintiff and representations made orally in connection with that sale. Vincent v. Thompson, 50 App. Div. 2d 211, 220, 377 N.Y.S.2d 118, 126-27 (2d Dept. 1975).

> or question actually litigated and determined in the original action, not what might have been thus litigated and determined. Only upon such matters is the judgment conclusive in another action."

See also Lawlor v. National Screen Service Corp., 349 U.S. 322, 326 (1955).

Further refinements to this articulation have resulted in the classic elements of collateral estoppel.

> 1. There must be a valid, final judgment in the prior litigation.
>
> 2. The question of fact decided in the prior litigation must have been essential to the judgment.
>
> 3. The question of fact must have been actually litigated and determined.
>
> 4. The question of fact must be identical with the one presented in the second litigation.
>
> 5. The party against whom collateral estoppel is asserted must be a party, or in privity with a party, to the earlier adjudication.
>
> 6. The party asserting estoppel must be a party, or in privity with a party, to the earlier adjudication.

Restatement of Judgments §§ 68, 93 (1942); 1B J. Moore & T. Currier, Federal Practice ¶ 0.412[1] (2d ed. 1974). See Scooper Dooper, Inc. v. Kraftco Corp., 494 F.2d 840, 844 (3d Cir. 1974). Compare Bernhard v. Bank of America National Trust & Savings Ass'n, 19 Cal. 2d 807, 813, 122 P.2d 892, 895 (1942).

Notwithstanding a number of narrow and particularized decisions governing specialized areas of the law, mutuality of estoppel remains the law both of the Second Circuit and also of a substantial number of other jurisdictions.* Although UHF correctly notes the movement away from the necessity of mutuality in specific instances, it exaggerates the distance covered and the generality of the supposed trend.** Repeatedly in recent years courts have refused the wholesale abandonment of mutuality and have instead made narrow exceptions where necessary, recognizing that careful development of new rules is the optimal mode of resolving the sometimes competing interests of judicial economy and fairness to the individual. E.g., Spettigue v. Mahoney, 8 Ariz. App. 281, 445 P.2d 557 (1968); Keith v. Schiefen-Stockham

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* See generally Mackris v. Murray, 397 F.2d 74, 77-78 (6th Cir. 1968) (Michigan law); Semmel, Collateral Estoppel, Mutuality and Joinder of Parties, 68 Colum. L. Rev. 1457, 1461 & n.22 (1968); Annot., 31 A.L.R.3d 1044, 1059 (1970); 46 Am. Jur. 2d, Judgments §§ 520-23 (1969).

** Some courts have concluded that the abandonment of mutuality for purposes of collateral estoppel is inconsistent with our adversary system of justice. E.g., Howell v. Vito's Trucking & Excavating Co., 386 Mich. 37, 191 N.W.2d 313, 319-20 (1971); Spettigue v. Mahoney, 8 Ariz. App. 281, 445 P.2d 557, 562 (1968). See also 1B J. Moore & T. Currier, Federal Practice ¶ 0.412[1] (2d ed. 1974).

Insurance Agency, Inc., 209 Kan. 537, 498 P.2d 265 (1972); Adamson v. Hill, 202 Kan. 482, 449 P.2d 536 (1969); Howell v. Vito's Trucking & Excavating Co., 386 Mich. 37, 191 N.W.2d 313 (1971); Albernaz v. City of Fall River, 346 Mass. 336, 191 N.E.2d 771 (1963) (mutuality required for offensive use); Wright v. Holt, 18 N.C. App. 661, 197 S.E.2d 811, cert. denied, 283 N.C. 759, 198 S.E.2d 729 (1973); Armstrong v. Miller, 200 N.W.2d 282 (N.D. 1972) (mutuality required for offensive use).

The Court of Appeals for this Circuit has been particularly clear on this point. In Divine v. Commissioner, 500 F.2d 1041, 1046 (2d Cir. 1974), it stated:

> "It would be incorrect, however to assume that the requirement [of mutuality] has met its demise."

See also Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation, 402 U.S. 313, 327 (1971); Berner v. British Commonwealth Pacific Airlines, Ltd., 346 F.2d 532 (2d Cir. 1965), cert. denied, 382 U.S. 983 (1966).

Similarly, it has been held that "[t]he rule of non-mutuality is not a general one but a limited one in each case whether or not it should be applied." Unites States v. United Air Lines, Inc., 216 F. Supp. 709, 726 (E.D. Wash., D. Nev. 1962), aff'd as to res judicata sub nom. United Air Lines, Inc. v. Wiener, 335 F.2d 379 (9th Cir.), cert. dis-

missed, 379 U.S. 951 (1964). And one seeking to escape the requirement of mutuality bears a heavy burden of persuasion. See Costello v. Pan American World Airways, Inc., 295 F. Supp. 1384, 1389-90 (S.D.N.Y. 1969); Hawaiian Paradise Park Corp. v. Becker, 314 F. Supp. 1133 (D.D.C. 1970).

Divine v. Commissioner is particularly instructive, because there the Second Circuit recognized the criticisms of mutuality of estoppel, see Bernhard v. Bank of America National Trust & Savings Ass'n, 19 Cal. 2d 807, 122 P.2d 892 (1942), and nonetheless reaffirmed its vitality. Compare Ritchie v. Landau, 475 F.2d 151, 155-56 (2d Cir. 1973) (Waterman, J.) (New York law). The Divine Court also considered in detail the circumstances in which a departure from the mutuality requirement was warranted, and articulated its standard for identifying the cases in which collateral estoppel may appropriately be employed.

A reading of Divine illustrates that in the particular circumstances of this case UHF is barred in limine from relying on collateral estoppel. Because the rationale of Divine is precisely in point it may be useful to consider it in some detail.

Divine arose in the context of tax litigation. The taxpayer claimed that collateral estoppel precluded the Internal Revenue Service ("IRS") from litigating the substantive tax question at issue, on the ground that the IRS

had previously lost on that precise question in the Court of Appeals for the Seventh Circuit. The apparent response of the IRS was to contend that because the taxpayer would not have been bound by an adverse decision in the Seventh Circuit, he could not claim the advantage of a favorable one. In other words, the IRS argued that mutuality was still required for the successful assertion of collateral estoppel. The Court of Appeals for this Circuit agreed.

The Court first noted that policy considerations dictate what classes of cases are amenable to collateral estoppel treatment and recognized that this was the rationale underlying Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation, 402 U.S. 313 (1971), and Zdanok v. Glidden Co., Durkee Famous Foods Division, 327 F.2d 944 (2d Cir.), cert. denied, 377 U.S. 934 (1964).

The Court reasoned that in Blonder-Tongue, dictates of public policy peculiar to patent cases had persuaded the United States Supreme Court to abandon the mutuality requirement for patent litigation. 500 F.2d at 1048. A reading of Blonder-Tongue bears out this analysis. First, the Supreme Court took special care to limit its holding to cases involving the hypertechnical issues involved in determining the validity vel non of patents. 402 U.S. at 327, 329-30, 349. Second, that Court's rationale was based primarily, if

not exclusively, upon the economic consequences of continued adherence to the mutuality rule in patent litigation. Id. at 334-47. Third, only slight emphasis was placed on the "incidental matter" (id. at 349) of reduction of litigation as justification for the holding. In light of these three observations it would be serious error to conclude that Blonder-Tongue signalled a revolutionary approach to problems of mutuality. Rather, the opinion should be read as an indication of the heavy burden placed on one arguing for even selective abandonment of mutuality.

Although Zdanok is cited regularly as a leading case overthrowing mutuality of estoppel, the Court of Appeals in Divine did not concur in that interpretation:

> "At first blush Zdanok might appear to be comprehensive enough to foreclose a litigant's right to relitigate most legal issues. Subsequent cases, however, have perceived the characterization of the issue in that case as being one not 'subject to the varying appraisals of the facts by different juries,' 327 F.2d at 956, a ground for finding that certain classes of issues are not within the Zdanok rule."

500 F.2d at 1047 (emphasis added). See also Berner v. British Commonwealth Pacific Airlines, Ltd., 346 F.2d at 541; Fink v. Coates, 323 F. Supp. 988 (S.D.N.Y. 1971); Agrashell, Inc. v. Bernard Sirotta Co., 281 F. Supp. 704, 708 (S.D.N.Y. 1968).

The Court in Divine principally drew support for its reasoning from Fink v. Coates, a case with facts remarkably similar to those in the instant case. Fink v. Coates

was part of the Texas Gulf Sulfur litigation. A Utah action had resulted in that district court's finding that Texas Gulf Sulfur ("TGS") had issued a misleading press release. Thereafter, other plaintiffs sought in a New York action to collaterally estop TGS from litigating the issue of whether or not the press release was misleading. Distinguishing Zdanok, Judge Bonsal refused to permit an exception to the doctrine of mutuality and denied plaintiffs' motion for summary judgment.

The distinction in Fink v. Coates recognized as most persuasive and adopted by the Second Circuit in Divine was based on the fact that "Zdanok involved an interpretation of a contract, whereas these are tort actions involving falsity, materiality and scienter." 323 F. Supp. at 990. As the Second Circuit explained in Divine,

> "[i]n refusing to apply collateral estoppel, Judge Bonsal . . . distinguished Zdanok, at least partially, on the ground that the issue in Zdanok was one the resolution of which would be the same in any forum. As evidence of the fact that the issue of the defendants' knowledge of falsity was a difficult one and one subject to varying appraisals, the court adverted to the language of judges of the Second Circuit and the Southern District of New York rendered during the course of the principal Texas Gulf Sulfur litigation, which language fell short of stating that there was knowlege of falsity. . . . These judicial views were thus incompatible with the opinion of the district court for the District of Utah and clearly demonstrated that the resolution of the legal issue of knowledge of falsity might very well differ from forum to forum."

500 F.2d at 1047-48 (citations and quotations omitted). Accord, Berner, 346 F.2d at 541.

The lesson of these cases, then, is that in order for a stranger to a prior judgment to assert its collateral estoppel effect against the losing party in the earlier action, the issue sought to be precluded must not be one "subject to varying appraisals of the facts by different juries." Accord, Lipton v. Richard Franchise Investment, Inc., [Current] CCH Fed. Sec. L. Rep. ¶ 95,422, at 99,156 (S.D.N.Y. Jan. 28, 1976). As indicated hereafter, this case, like Fink v. Coates, involves precisely such issues, and is accordingly inappropriate for application of the doctrine of collateral estoppel in the absence of mutuality.

Factually there are additional reasons why this Court should determine the issue of good faith independently of the Franklin decision. During the Franklin trial a substantial amount of evidence which was received by this Court was either proffered by Goldman, Sachs and rejected by Judge Metzner or was not offered because of what we understood was the Court's ruling in our favor on those issues. For those reasons Goldman, Sachs moved to amend the judgment in the Franklin case, a motion which was denied only this month. To avoid further lengthening of this brief we are submitting with this brief a copy of our memorandum in support of the

motion pursuant to Rule 52(b) and 59(a) in the Franklin case, which memorandum sets forth in detail the evidentiary differences -- on the very issue sought to be foreclosed -- between the Franklin record and the record of this trial.*

The differences in the trial record between Franklin and this case, not to mention the basic fact that a decision on good faith turns essentially on varying appraisals of demeanor and creditibility by both Courts sitting as triers of fact, also militates against plaintiff's suggestion concerning judicial comity.

Stated simply, should this Court agree with Judge Metzner on the issue of good faith, then consideration of collateral estoppel introduces an extraneous and unnecessary element into the decision of this case. If this Court disagrees with Judge Metzner, that determination should thereby render inappropriate any application of collateral estoppel

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* Under even the most permissive view of the circumstances in which collateral estoppel may be invoked, it is essential that the party who is to be estopped must have been afforded in the earlier trial a "full and fair opportunity to litigate." See, e.g., Blonder-Tongue Laboratories, Inc., v. University of Illinois Foundation, 402 U.S. 313 (1971); Zdanok v. Glidden Co., Durkee Famous Foods Division, 327 F.2d 944 (2d Cir.), cert. denied, 377 U.S. 934 (1964). For the reasons set forth in defendants' memorandum in support of its motion to amend the judgment in Franklin, the decision there was made without affording defendants the requisite opportunity to develop evidence on points essential to that judgment.

because this Court would be convinced that the earlier factual determination was incorrectly decided. See Vincent v. Thompson, 50 App. Div. 2d 211, 377 N.Y.S.2d 118 (2d Dept. 1975).

B. Goldman, Sachs' Reduction of Inventory Was Made for Sound Business Reasons Bearing No Relationship to the Creditworthiness of the Company

It is undisputed that on February 9, 1970, Goldman, Sachs sold back to Penn Central $10 million of commercial paper that had previously been held by Goldman, Sachs in its inventory. It is also undisputed that April 7, 1970 was the last business day on which Goldman, Sachs had an inventory of Penn Central paper at the close of business. (See Exhibit CW). By taking these two facts out of context, plaintiff attempts to argue that each, or perhaps both together, reflect an evil state of mind and an intention to reduce inventory because of Goldman, Sachs' own fear that Penn Central was going bankrupt. No evidence supports this interpretation of events. Rather, the facts presented by Goldman, Sachs show that these two occurrences were the result of rational decisions and sound business practices bearing no relationship to any credit judgment about Penn Central.

Because plaintiff's attack upon Goldman, Sachs' inventory reduction is really an attack upon a business

decision that can best be understood in the context in which it was made, it is necessary to discuss briefly the nature of inventory, the difficulties which had arisen in connection with customary inventory practices and the conclusions which Goldman, Sachs reached about inventory generally during the relevant time period.

Traditionally, inventory had been a means of making available for immediate sale commercial paper notes that had maturities and were in amounts which an issuer desired to sell. When commercial paper was first used, issuers mailed their pre-set notes to Goldman, Sachs and, as of the date those notes bore, they became part of Goldman, Sachs' inventory and could be resold for immediate delivery. This method had the advantage for the issuer of assuring funds by a certain date; and had the advantage for Goldman Sachs of assuring a stock of available paper to offer to investors. In addition, by purchasing from an issuer the precise notes that it wished to distribute, inventory became a self-regulating device that assured that notes offered would meet the issuer's borrowing needs. (Van Cleave, Tr. 275-76).

In the ordinary case, the purchase of paper for Goldman, Sachs' inventory provided the issuer with an immediate market for its notes and a reliable source of cash in

advance of actual sales to investors in the marketplace. This function of inventory, however, had always been secondary to the function of providing paper immediately available for sale in the correct amounts and maturities to meet the issuer's needs. Goldman, Sachs never undertook to guarantee an inventory of a particular size to any issuer.*

During the period that Penn Central commercial paper was being offered, the total amount of outstanding commercial paper sold through Goldman, Sachs grew considerably, and with it grew the size of Goldman, Sachs' inventory. These parallel developments are reflected on Exhibit CW.

As long as rates changed slowly, if at all, the risk of loss from inventory practices and the inconvenience due to market fluctuations were minimal, and inventory remained a satisfactory selling device. (Van Cleave, Tr. 275-76). During 1969, and particularly in the fall of that year, Goldman, Sachs became increasingly aware that the traditional concepts of inventory outlined above were becoming outmoded because of substantial practical problems which had then recently emerged.

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* Penn Central was informed of this policy, as is reflected in Exhibit A-110.

Two kinds of costs often resulted from carrying inventory, and are referred to respectively as "negative carry" costs and "mark-up" costs.

Negative carry results from the fact that Goldman, Sachs is required to borrow the money which it uses to purchase paper for its own inventory. The commercial paper in inventory, of course, earns interest at whatever rate is reflected in the purchase price of the note. (Doty, Tr. 687). Whenever the rate at which Goldman, Sachs is required to borrow money to finance paper in inventory exceeds the rate of return on the paper itself, Goldman, Sachs loses money on that inventory operation (Doty, Tr. 687-89; Van Cleave, Tr. 276). Exhibit CL shows that during 1969 money market rates rose substantially, and the cost to Goldman, Sachs of borrowing money grew with it. Although the commercial paper rate rose as well, there was a substantial period when the rate earned on commercial paper was not as high as the rate Goldman, Sachs was required to pay.

In the year ended September 30, 1969, the negative carry loss to Goldman, Sachs on commercial paper in inventory was $930,000 (Ex. PX-75; see Van Cleave, Tr. 290-91).

Besides losses arising from negative carry, substantial losses resulted from the necessity of selling paper at a higher discount rate (i.e., lower price) than that at

which it was purchased. The size of these losses varied from issuer to issuer, and depended upon the relationship between rate changes in the market and the saleability of particular paper in inventory. For example, Goldman, Sachs may hold in inventory a note it purchased at 8-1/2% for resale in the market at the then current rate of 8-3/8% (i.e., a typical price mark-up of 1/8%). If the selling rate then rises to 8-1/2%, Goldman, Sachs will not be able to sell the note except at that higher rate. This means that the discount price at which the note is sold is the same as -- and in other cases may actually be lower than -- the price at which Goldman, Sachs purchased the note. The result in the latter situation is a net loss on the transaction. (Van Cleave, Tr. 276-77).*

The entire process resulting in losses with respect to particular transactions may be illustrated by an example drawn from Exhibit CU, the computer print-out which reports each transaction in Penn Central commercial paper during the entire time that it was sold by Goldman, Sachs. This example involves paper purchased by Goldman,

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* This process of marking down the price at which the note will be offered, which is equivalent to marking up the rate, is sometimes called "distress selling" in the commercial paper business. The term bears absolutely no relationship to the creditworthiness of the issuer. (Van Cleave, Tr. 304)

Sachs on October 30, 1969 and ultimately sold on November 19, 1969:

On October 30, the purchases made by Goldman, Sachs included $1,350,000 face amount of paper maturing on January 22, 1970. The rate at which that paper was purchased was 8.375%. (See Ex. CU, at 225).

One million dollars face amount of that paper remained in inventory until November 19 when it was sold to the Oppenheimer Fund, Inc. at a price reflecting a selling rate of 8.80%. (Ex. CU, at 243).*

This mark-up from 8.375% to 8.80% (which is the equivalent of marking down the price) resulted in a loss on the Note of $755.55.**

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* Meanwhile other Penn Central notes of different maturities and face amounts were being regularly bought and sold both on a same-day basis and from inventory. Indeed, more than $60 million of Penn Central paper was sold by Goldman, Sachs during this three and one-half week period. (See Ex. CW).

** Because the note is sold at a discount, the loss is reflected in the price of the note at the time of sale. The portion of the dollar difference between the purchase price and sale price attributable to the mark-up is calculated by determining the interest for the remaining life of the note at the interest differential rate, here .425%. The calculation follows:

8.80 (selling rate) - 8.375 (buying rate) = .425%.

$$\frac{64 \text{ days (remaining to maturity)}}{360 \text{ days (investment year)}} \times 1{,}000{,}000 \times .425\% = \$755.55$$

In addition, because the rate at which paper was financed exceeded the buying rate during the period it was held in inventory, there was a further loss incurred by Goldman, Sachs as a result of "negative carry". Looking at Exhibit CS, it can be seen that the average financing rate exceeded 9% -- as compared to a buying rate on this paper of 8.375%. Although it is not practical to determine exactly what financing rate was paid on any particular note, a reasonably accurate negative carry cost can be determined by calculating the interest paid at the weighted average finance rate for each of the days between October 30 to November 19, 1969. On that basis, the approximate additional cost to Goldman, Sachs for negative carry amounted to $428.06.*

The total loss on the transaction due to mark-up and negative carry was therefore $1,183.61.

Obviously, most transactions do not result in a net loss as did this illustration. The transaction described, however, is not an isolated example, and many other instances of net loss due to one or both of the factors described may be found in Exhibit CU. The aggregate cost of marking up

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* The figure is the sum of the dollar amount of the difference between the buying rate and the average financing rate for each day the paper was in inventory.

paper and the aggregate loss resulting from negative carry consumed a substantial portion of the gross profit on total commercial paper sales, thus reducing the overall profitability of the department. (Ex. PX-75, at 5; Doty, Tr. 892-94).*

Also, the increasing use of special order paper -- tailor made to fit the investor's needs -- significantly altered the role of inventory in the sales effort. Special order paper, when combined with "tap" issuance, allowed Goldman, Sachs to deliver notes to an investor's New York bank in any amount and maturity upon which agreement had been reached. Because an investor could thereby choose the precise amount and maturity it desired without regard to what particular notes might be in inventory, it was often easier to sell paper on the special order basis. As a result, some paper continued to languish in inventory while special order paper of the very same issuer sold briskly. (Doty, Tr. 695-96).

Not only was special order paper more appealing to investors, it was also easier for a salesman to sell because availability could be determined by calling across the trading

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* Doty's concern is also reflected in a November, 1969 memorandum written at his request (Ex. FA) in which Hyman Weinberg, then Goldman, Sachs' Controller, studied the problem of aging paper in inventory. Doty noted that as interest rates rose, the aging of paper in inventory became a more serious problem. (Doty, Tr. 688-89, 696-97).

room rather than telephoning the Note and Discount Department. (Van Cleave, Tr. 289-90).

Inventory sales were sometimes slowed by the method of financing inventory known as "repos," or repurchase agreements. A certain amount of inventory was financed each night at a lower rate than ordinary bank borrowing charges. These financing arrangements were ordinarily with out-of-town banks or industrial corporations, and consisted of transactions which were technically purchases of commercial paper from Goldman, Sachs with an agreement by Goldman, Sachs to repurchase the paper one or two days later. In many cases, the other party to the repo transaction wished to complete its arrangements before the end of the selling day. Paper financed by this method was therefore unavailable for delivery even before the 12:30 P.M. cut off. Any paper in inventory financed by this means was less saleable, both because the period of the day in which it could be offered was sharply reduced and because it may have been difficult to retrieve for sale the following day. (Van Cleave, Tr. 289-90; Doty, Tr. 696).*

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* Repos were a recognized problem in the case of Penn Central as is shown by Lepley's notes for January 14, 1970 (Ex. BI): "A lot of inventory is tied up in 'repos' so can't get rid of this until things 'shake loose.'"

These technical difficulties slowed the pace of inventory sales even further and, in a time of rising rates, contributed to the necessity of marking up paper and selling it, in many cases at a substantial loss.

Even apart from the costs associated with inventory, its size alone caused problems in terms of Goldman, Sachs' relationship with its banks and its ability to operate efficiently. (Doty, Tr. 681-91). For these reasons the Management Committee, at the behest of George Doty who had become concerned about the difficulty of obtaining overnight financing in tight money periods, imposed a $250 million ceiling on total inventory of commercial paper of all issuers. (Doty, Tr. 690-91). Although this "ceiling" was flexible and periodically exceeded (see Ex. CU, column 11), it necessitated additional marking up of paper in inventory for quick sale in order to keep below the ceiling.

During 1969 Goldman, Sachs became increasingly aware of all the problems outlined above caused by the maintenance of inventory. (Doty, Tr. 694). A study of the operations of the commercial paper department, undertaken by Wilson and Van Cleave, among others, prompted this new awareness. That study culminated in "A Report on the Commercial Paper Department Prepared for the Management Committee and the Partnership" (often called the "Blue Book") (Ex.

PX-75). The Blue Book, although dated March 1970, was based in large part upon a series of statistical analyses which were available and being studied within the commercial paper department beginning in early December of 1969. "We began obtaining results immediately as soon as we started to work on it. We actually put this document together and it was finished some time in March, but we had knowledge of the results in late '69." (Van Cleave, Tr. 291-92).

Part of the impetus for the Blue Book Report came from a conference of the Goldman, Sachs partnership held at Sterling Forest, New York in the fall of 1969. At that time the Commercial Paper Department was criticized both for its comparatively poor profitability and for its high selling rates which tended to irritate issuers who were, in some cases, important clients of Goldman, Sachs for other purposes. (Doty, Tr. 691-94).

Up to the time of that conference and the commencement of the Blue Book study at about the same time, Wilson and Van Cleave had generally taken the position that the high selling rates and resultant dissatisfaction among issuers was caused by Doty's efforts to hold down the size of inventory -- which of necessity meant "marking up" paper for quick sale in order to make more room in inventory for new paper. (Van Cleave, Tr. 297-99; Ex. PX-121 (BQ)). Only

when the statistics from the study, coupled with low profitability, were considered in depth did it become apparent that reduction of inventory was necessarily the long term solution to the problem. (Doty, Tr. 696; Van Cleave, Tr. 299-301).

The Blue Book study examined both negative carry and mark-up costs. It concluded that the negative carry cost for the year ending September 30, 1969, was $1,300,000 and that the mark-up cost during that same period was $1,372,147. (Ex. PX-75, at 5). In addition, the authors of the Report took note of the saleability problems that resulted from excess inventory as compared to special order of sales of commercial paper. (Id.).

On the basis of the available statistics and review of procedures, the authors reached a conclusion in late 1969 and early 1970 which is of great significance to this litigation. (Van Cleave, Tr. 296). The summary of that conclusion in the Report is offered here because it is a succinct contemporaneous statement on this critical issue:

> "This study has convinced us it is not necessary or desirable to inventory commercial paper. The market has changed in the last five years. Formerly, we called an issuer three days in advance, set the maturity, denominations and rate, and had the company mail the notes to us. In this type of transaction the purchase was for inventory and not for special order. The concept of inventorying is out of date in today's market. Our selling day is

> now compressed into a two-hour period between 10:30 a.m. and 12:30 p.m. New York time. The investor wants delivery of the actual notes and usually will not take due bills. The investor wants to choose the maturity, not work out of Goldman, Sachs' inventory with its prearranged maturity dates. The investor wants quick answers as to whether we can complete a sale. On a recent sales day of $326 million, $316 million of it was special order and never appeared in Goldman, Sachs' inventory. More surprisingly, Goldman, Sachs & Co.'s inventory at the start of that day was $225 million and closed the day at $225 million."

(Ex. PX-75, at 5).

Accordingly, beginning in the fall and early winter of 1969, Goldman, Sachs began certain programs to control the size of inventory:

> Q. What did you do to implement this change.
>
> A. We started on a case by case basis in making the rounds to our issuing companies to convince them that this was the best way to do business and to give it a try.
>
> * * *
>
> Q. When was that started, when did you start --
>
> A. In late '69. Early '70.
>
> Q. Which issuers did you work on, I think is the phrase?
>
> A. We worked on those that would be the larger positions in our inventory.
>
> Q. The top 10?
>
> A Yes, right.

(Van Cleave, Tr. 302).

The significance of reliance upon swing line and tap issue sales was that the combination of these two techniques provided a workable alternative to inventory (Van Cleave, Tr. 301-02). A swing line is a line of credit available for immediate use on a short-term basis. That is, a swing line allows an issuer to borrow money overnight to be repaid the following day. (Van Cleave, Tr. 296). Tap issue is an arrangement by which an issuer's New York bank can be authorized by telephone to fill in the amount and maturity on blank notes lodged with the bank so that immediate delivery of special order notes is possible. (Van Cleave, Tr. 254-56).

The availability of these techniques meant that Goldman, Sachs could sell paper on a special order basis for immediate delivery and, if all the paper an issuer wished to sell was not in fact sold during the course of the day, the issuer could be advised to borrow from its swing line the difference between actual and desired outstandings. By this means, inventory was supplanted by tap issue arrangements for its traditional purpose of creating immediate availability and by swing lines for its secondary lending function.

During late 1969 and into 1970 Goldman, Sachs approached a number of issuers to persuade them to reduce their dependence upon inventory, either by obtaining swing lines or reducing outstandings. Part of this effort is reflected

in Exhibit BM which shows targets of limits imposed on the total inventory which would be allowed with respect to certain finance company issuers. Van Cleave elaborated at trial:

> A. Because finance companies were a natural for a ceiling because they were in the market as I mentioned before, constantly. They were always in the market and therefore we were helping to finance their position.
>
> THE COURT: They were the friskiest horses in the corral and you wanted to put the muzzle on them first?
>
> THE WITNESS: Not risky --
>
> THE COURT: I said frisky.
>
> THE WITNESS: Absolutely.
>
> THE COURT: I mean active.
>
> THE WITNESS: They were in all the time and they were actually more familiar with this type of operation than some of the industrial companies were. We knew back as early as 1969 to the extent we could get some of these people to do their own financing, it would be to our advantage. So we started off with the finance companies to see how that would work.

(Van Cleave, Tr. 313-14).

In addition to the finance companies which were constantly in the market, there were certain industrial companies that also were not seasonal and were in the market consistently. (Van Cleave, Tr. 314-15). "Seasonality" was

significant because it distinguishes issuers with particular maturity requirements from other issuers who were constantly in the market. The latter type of issuers did not require specific maturity dates and for them special order arrangements improved sales.

Apart from Penn Central which will be considered separately hereafter, "[t]here were three or four other companies that we were experiencing the same problem in that we always had large positions in inventory and we were doing everything we possibly could to get them to establish swing lines. So we did then establish internal guidelines as far as their inventory positions were concerned." (Van Cleave, Tr. 315). There were of course still other companies that cooperated in setting up swing lines and reducing inventory without the necessity of establishing even informal guidelines.

At the same time, other techniques were used for preventing the accumulation of stale paper in inventory. For example, paper in inventory would occasionally be returned to the issuer in the morning so that that block of paper could be sold on a special order basis. (Van Cleave, Tr. 305-07). If it was not sold during the course of the day, the remaining amount would be taken into inventory. The advantage was that during the course of the day offerings could be made

in any amount and maturity and were not limited to the specific items in inventory. In some cases, this improved saleability and therefore held down inventory. (Van Cleave, Tr. 306-07). As indicated hereafter, it was not sufficiently successful in the case of Penn Central to solve the inventory problem. (Van Cleave, Tr. 309-10).*

* * *

It is against this background that the reduction of Penn Central's inventory must be viewed.

Exhibit CW shows that during the fall of 1969 the size of Penn Central's inventory was a persistent problem, rising over $15 million on numerous occasions. The blue sheets and testimony show that in the late fall Goldman, Sachs complained regularly about the size of the Penn Central inventory it was being forced to carry. Consistent with the background considerations explained above, Lepley testified that the reason for these complaints as he understood it at the time was that inventory was becoming increasingly expensive for Goldman, Sachs. (Lepley Dep. 7-9)

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* The names of the issuers whose paper was heaviest in inventory were also read daily to all salesmen so that they could be sure to include them in their offerings, where appropriate. (Van Cleave, Tr. 267-69; Ex. DX).

It was not only in telephone conversations that the subject of inventory arose. During a face-to-face meeting among Van Cleave, Lepley and others on December 9, Van Cleave urged that Penn Central obtain additional swing lines so that it could reduce its reliance upon Goldman, Sachs' inventory. (Van Cleave, Tr. 451-52; Lepley Dep. 27; see Exs. PX-22 (A-79) and PX-87(BU).

Repeated complaints by Goldman, Sachs thereafter finally resulted in some action by Penn Central on December 23, 1969. At or about that date Penn Central obtained substantial funds as a result of the Pennsylvania Company's successful bond offering, the proceeds of which were lent "upstream" to Penn Central Transportation Company. Some of the funds so obtained were used to repurchase $16 million of commercial paper from Goldman, Sachs' inventory. (Van Cleave, Tr. 437-38).

After the December reduction the inventory of Penn Central maintained by Goldman, Sachs remained comparatively low for several weeks. Thereafter, it again rose above $10 million on a consistent basis. (See Ex. CW). In January, Penn Central was on Goldman, Sachs' list of top 10 issuers in inventory almost every day and was first on that list approximately one half the time. (Van Cleave, Tr. 302-03). The concern to Goldman, Sachs caused by this steady

increase is reflected in the notes maintained by Lepley of his conversations with Goldman, Sachs' personnel during January. The remarks contained in those notes -- as well as Van Cleave's testimony -- give a consistent picture of regular communication on the problem of inventory. (Ex. BI, sheets dated January 2, 5, 13, 14, 15, 20 and 23*; Van Cleave, Tr. 302-03).

At the root of the problem was O'Herron's refusal to obtain swing lines as an alternative to inventory. His reason was straightforward. As Van Cleave explained,

> Well, they [Penn Central] knew that it would be expensive for them to get additional bank lines, and they had this terrific deal from Goldman, Sachs who was taking the paper in and financing it and taking the losses instead of themselves, and so it was very difficult to negotiate with them, to change that.

(Van Cleave, Tr. 443).

By February 4, 1970, when Penn Central announced its 1969 year-end financial results, it was apparent that

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* At the conclusion of live testimony defendant offered in evidence all of Exhibit BI. Although counsel for plaintiff first voiced an objection to the exhibit on the grounds of authenticity and hearsay it appeared that the thrust of the objection was to the admission of handwritten notes the meaning of which might not be clear without the aid of live testimony (Tr. 1047). The Court concluded that BI constituted a business record, and we understand it to have held that so much of BI as was self-explanatory and required no testimonial interpretation was admissible (Tr. 1050-51). We have accordingly cited only to notations in Exhibit BI the meaning of which is apparent on the face of the document or by reference to the deposition of Levy which is part of this trial record.

the simple repurchase of notes by Penn Central on a single occasion, as had been done in December, was insufficient to control the problem of inventory. It was also apparent that the technique of temporary returns from inventory on a daily basis was likewise insufficient -- although it was certainly tried. (See Ex. BI for January 30, 1970; Van Cleave, Tr. 306-07.

When the February 4 press release provided the opportunity for further action, Wilson seized it. On February 5, Wilson called O'Herron to obtain additional information regarding the significance of the announced results, and, during the course of his discussion, told O'Herron that because the announcement of an operating loss could result in a slowdown of commercial paper sales and a further accumulation of unnecessary inventory, Goldman, Sachs would no longer inventory Penn Central in the amounts previously accepted. The next day, in further discussions, he set a limit of $5 million. (See Exs. PX-11 (A-71) and PX-12 (A-69)).

Wilson has testified that he imposed that $5 million limitation for at least two reasons: First, to reduce the total cost of carrying Penn Central commercial paper in inventory; second, because he felt that the announcement gave him the opening to force Penn Central to reduce its dependence upon inventory and turn instead to

swing lines, thereby making its commercial paper more saleable. (Wilson, Tr. 1101-03). The history of complaints by Goldman, Sachs and of insufficient response by Penn Central all through the fall and winter confirms that this action was necessary.

As a result of Wilson's discussions on the 5th and 6th of February Penn Central agreed to convert some of its backup lines to swing lines and to use those lines as an alternative to inventory. Goldman, Sachs then sold back $10 million of commercial paper to Penn Central and imposed a $5 million limitation upon the size of Penn Central inventory for the future.

However the $5 million working arrangement is labeled, it amounted to a guide line that was ordinarily followed but was occasionally exceeded. The undisputed statistics confirm that after February 9, 1970 when inventory was reduced by $10 million, it continued to fluctuate for two months, dropping to zero at the end of February and rising as high as $9 million almost immediately thereafter. (See Ex. CW). What is apparent is that, while inventory fluctuated, the use of swing lines improved sales so that inventory reductions were possible without reducing the paper outstanding.

Far from representing a fearful reaction to the announcement of the 1969 results, the inventory

reduction of February 9 was thus part of a long-standing pattern of attempting to solve the inventory problem. That pattern included a much larger reduction of inventory by the December sale back to Penn Central, a month and a half before the 1969 results were announced. The February 9 reduction -- except for its smaller size -- was essentially indistinguishable from that earlier effort.

Moreover, the reduction of inventory for a commercial paper issuer was not an unusual occurrence for Goldman, Sachs. At trial, Wilson explained that during the tight money market of 1968, 1969 and 1970, Goldman, Sachs many times returned commercial paper to an issuer, and specifically pointed to returns to Avco Corporation (Ex. FK) and the Dow Chemical Company (Ex. FL). Both Exhibits FK and FL, coupled with Wilson's testimony, demonstrate that returns to company were a regular part of Goldman, Sachs' business. Indeed, that the February 9, 1970 return of commercial paper to Penn Central was done for market rather than for credit reasons is seen from its similarity to a July 25, 1969 return of commercial paper to Avco. Wilson explained the circumstances of that return:

> That we were experiencing a tough money market in July, that the Avco notes were not selling as freely in the market as we would like, and therefore inventory was high in Avco notes, and we were exploring with . . . the man we dealt with, and we were exploring with him if he could take back some of our inventory.

> On July 22nd he indicated he might draw down his compensating balances that he had at his bank to take back the paper, but then on the 24th he said he had received cash from the sale of some property, and he would be glad to use the proceeds from the sale of that property to take back the paper which he did, on the 25th.

(Wilson, Tr. 922-23).

It is illogical, moreover, to claim the February 9 reduction indicated a loss of confidence when it is undisputed that on March 13, 1970, the date UHF purchased its Penn Central commercial paper note, Goldman, Sachs' inventory of Penn Central was $4.7 million. (Van Cleave, Tr. 336). That amount, which Goldman, Sachs owned as principal and which it had at risk on that day, was over seven times the face amount of paper purchased by UHF, and was among Goldman, Sachs' ten largest inventory positions that day. (See Ex. DX). It is incredible to suggest that Goldman, Sachs would have owned commercial paper in that amount if it had -- as plaintiff claims -- lost confidence in Penn Central.

C. Other Events Corroborate the Good Faith of Goldman, Sachs

Plaintiff has apparently abandoned any contention that Goldman, Sachs' judgment was colored by its desire to realize substantial other business from Penn Central and therefore concealed the imminent bankruptcy of that "lucrative" client. Nevertheless it is noteworthy on the issue

of good faith to compare the relative importance of the clients to whom Goldman, Sachs sold Penn Central commercial paper with the relatively insignificant revenues received from Penn Central during this period.

Exhibits PW and PX show that the total Goldman, Sachs gross revenues, exclusive of commercial paper, received during the 1968-70 period from Penn Central. When compared with the substantial brokerage commissions received from such Penn Central commercial paper investors as Mellon National Bank and others (see generally Doty Testimony, at Tr. 697-701), it becomes ludicrous to suggest that Goldman, Sachs -- (by whatever standard judged, a firm of intelligent businessmen) -- would jeopardize these substantial relationships in order to curry the business of a future bankrupt. As Mr. Doty testified, many of the investors purchasing Penn Central commercial paper were the very banks which furnished the funds with which Goldman, Sachs conducted its business, and without which Goldman, Sachs could not survive for a single day. Coupled with this was the unchallenged testimony of Mr. Vogel that his recommendations to discontinue an issuer for credit reasons were never overruled, even in those cases where the issuer was a long-valued client of the firm (see Vogel, Tr. 670-71; see also Vogel Dep. 69-71). Mr. Levy also testified that the Management Committee never

interfered with the Commercial Paper Department in matters of credit judgment (Levy, Tr. 746; Levy Dep. 191-92).

Finally, there were two instances which occurred after plaintiff's purchase which should be determinative of the good faith belief of those at Goldman, Sachs who dealt with Penn Central in the continued viability of that client. First was the testimony by Mr. Levy that, as trustee with sole discretion of a "blind trust" for a close personal friend who had been a director of Penn Central, he concluded not to dispose of Penn Central stock in the spring of 1970 because in his view the stock was underpriced. (Levy, Tr. 762-66). Anyone capable of believing that Goldman, Sachs acted in February out of cupidity could not expect that the senior partner of that firm would forego the opportunity to protect his close personal friend by disposing of Penn Central stock in the spring of 1970.

Finally, another forceful example of the confidence with which Goldman, Sachs viewed Penn Central is the experience on May 27, 1970, just one day before the Pennsylvania Company debenture offering was suspended, whereby Goldman, Sachs purchased as principal 70,000 shares of Penn Central common stock in a "block" transaction, assuming the market risk of disposing of those shares. (Tr. 769-71). Had Goldman, Sachs viewed Penn Central with the slightest doubt as to its

continued viability, it would hardly have been expected to take such a substantial market risk at that late date.

It is apparent that the basis upon which plaintiff urges Goldman, Sachs' bad faith or dishonesty is wholly without merit. Goldman, Sachs' reduction of Penn Central inventory was made for sound business reasons having no relationship to creditworthiness. Goldman, Sachs' other business relationships with Penn Central were insignificant and in any event there is absolutely no evidence connecting them in any way with its credit judgment. Accordingly, plaintiff fails to show the necessary scienter requisite to recovery under Rule 10b-5 and under common law. Plaintiff is thus forced back upon its alleged cause of action under Section 12(2) where it is confronted with the problem that no statement was made which was either false or rendered misleading by any fact not communicated. Because Goldman, Sachs' judgment of creditworthiness was both honestly held and reasonably based, plaintiff has failed in its effort to establish the elements of a cause of action under that section as well.

II. IN THE CIRCUMSTANCES UNDER WHICH UHF PURCHASED ITS COMMERCIAL PAPER NOTE, GOLDMAN, SACHS WAS UNDER NO DUTY TO COMMUNICATE THE INFORMATION UPON WHICH IT BASED ITS INDEPENDENT CREDIT JUDGMENT

In order to make the careful credit analysis upon which UHF and many other commercial paper investors chose to rely, Goldman, Sachs maintained regular communication with all its commercial paper issuers, including Penn Central. During conversations with financial officers of issuers, a substantial amount of information was obtained which was used in the course of Goldman, Sachs' credit analysis. For the most part, this information was recorded in blue sheets and kept in an issuer's credit file. (See Ex. A) There is no dispute that the information in those files -- including the Penn Central file -- was treated as confidential and was not routinely disclosed during commercial paper transactions.

Although some information contained in the credit files was on occasion communicated to investors who expressed an interest in particular matters, it is also undisputed that no one at Goldman, Sachs ever communicated such information either to Mr. Fitzpatrick or to Mr. LeMay.

With the benefit of hindsight UHF now claims that Goldman, Sachs had a duty to inform it of virtually all of

the contents of the Penn Central blue sheets as well as a variety of other information. However, "[a]ccount must be taken of all the surrounding circumstances to determine whether the fact under consideration is of such significance that a reasonable investor would weigh it in his decision whether or not to invest." Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir.), cert. denied, 414 U.S. 910 (1973).

As indicated hereafter, the circumstances surrounding this purchase by UHF through Union Bank are such that no duty arose to disclose the underlying facts which were weighed by Goldman, Sachs in reaching its judgment of creditworthiness. That judgment itself was the only fact which was material in the context of the market and the mode of operation of this plaintiff and its agent.

The situation is analogous to that presented in Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir.) cert. denied, 419 U.S. 830 (1974). That case involved plaintiffs' sale of their shares of defendant, a closely-held corporation, at a time when there was no public market for its shares and the sale price was determined by management's judgment of the "going price" for the shares. Plaintiffs claimed, inter alia, that management did not disclose its role in fixing this going price. The Court rejected this argument, holding the alleged nondisclosures to be immaterial saying:

> "[W]e do not think that detailed knowledge of the precise mechanism for establishing the 'going price' would have affected the choice of action of a reasonable person in the position of the [plaintiffs]."

490 F.2d at 419-20 (footnote omitted). In other words, the Arber Court looked only to the reasonableness of the defendant's basis for computing a "going price," and did not require disclosure of the various components of that judgment. Framed in terms of the instant case, the only relevant inquiry here is whether Goldman, Sachs had a reasonable basis for its judgment that Penn Central was creditworthy. As will be shown, in the circumstances, detailed knowledge of the discrete items of information weighed by Goldman, Sachs in reaching its judgment of creditworthiness would not have affected UHF's decision, and accordingly need not have been disclosed.

The most significant factors in assessing the context and circumstances of UHF's purchase were the expectations of UHF and its agent Union Bank regarding disclosure, the professionalism of the market as a whole and the practicalities of disclosure in the context of that market. These considerations suggest the uniqueness of the commercial paper market, which in turn necessarily affects the scope of required disclosure by a commercial paper dealer to a purchaser.

a. The Expectations of the Parties

Perhaps the most important facts to be considered in defining the relevant circumstances are those which demonstrate the complete and voluntary isolation of Mr. Fitzpatrick, the decision-maker in the transaction, from all information and expert advice. Despite some internally inconsistent testimony by both Fitzpatrick and LeMay, the credible evidence in the end demonstrates that neither UHF nor Union Bank expected or wanted any information from Goldman, Sachs.

It is undisputed that Fitzpatrick alone had responsibility for choosing investments for UHF and that he did so without reference to any information from any source:

> "When we had some funds to invest I would contact at least two of the local banks, through investment departments that is, and get a rundown of what was available and on that particular day as to the company, the rate, the maturity, and take the information I got from two or three banks and come to some conclusion and then I would order whatever I decided was the best investment at that time."

(Fitzpatrick, Tr. 106) (emphasis added) Fitzpatrick followed this ordinary practice in the case of Penn Central, and his own description of the decision-making process shows that unless he made that $600,000 investment in complete reliance upon someone else's ultimate judgment that all the commercial paper shown him was acceptable, it can only be said that his decision verged upon the irrational:

"Q. You made the decision as to which of the available names to select?

"A. Yes, I did.

"Q. And what did you tell Mr. LeMay, if anything, with respect to that decision?

"A. I said that Penn Central sounds great to me. My gut reaction was it's a huge industrial company in the country and as safe as the U.S. Government is, what I said at the time. I felt this would be a good decision."

(Fitzpatrick, Tr. 113). When, upon cross-examination, Fitzpatrick was asked again to explain why he had chosen Penn Central and why it had for him "an image of quality" he responded:

"Just general information as a huge company. Ever since I had been a boy I had heard of the huge Pennsylvania Railroad."

THE COURT: Where did you grow up?

THE WITNESS: In the West. My family was from New York, New Jersey. I heard my father talking about the Pennsylvania Railroad. I always had an image of it as being a huge, huge corporation.

Q. Is that your only basis for your image that you had in your mind about this being a quality corporation?

A. Well, I guess by osmosis I obtained impressions. They owned a lot of properties, a lot of real estate, I heard . . . . I just thought that they were enormous and one of the biggies.

(Fitzpatrick, Tr. 125).

Despite the touching picture of Mr. Fitzpatrick and his family sitting around the dinner table in California reminiscing about the huge Pennsylvania Railroad, it appears that Fitzpatrick made a $600,000 unsecured investment with the funds of a charitable corporation without making any substantive inquiry of any source. In his conversations with Mr. LeMay of Union Bank nothing whatsoever was said regarding the financial condition of Penn Central, and the company was not in any way singled out from among the list of names being offered for purchase on that day. (Fitzpatrick, Tr. 121). Neither did Fitzpatrick attempt to obtain any information regarding Penn Central either from LeMay or from any other source. (Fitzpatrick, Tr. 121).

Fitzpatrick's explanation of his behavior is less than satisfactory, largely due to diametrically opposed statements to the Court under oath within the space of a few minutes. Fitzpatrick's direct examination and part of his cross-examination consisted of an effort to persuade the Court that he looked to his bank to act merely as a conduit of routine market information. This effort on the part of Fitzpatrick was epitomized by a brief colloquy with the Court:

> THE COURT: Did you ask the bank to give you its own independent judgment with regard to the quality of any paper that you bought?

THE WITNESS: No, I did not.

(Fitzpatrick, Tr. 128). Immediately after giving this testimony the witness's attention was directed to his prior deposition testimony and he was then questioned:

> Q. Is it your testimony today that you expected the bank to put its stamp of approval on commercial paper being shown to you?
>
> A. Yes.
>
> Q. And you relied on that?
>
> A. Yes.

(Fitzpatrick, Tr. 130).

The reason for what can charitably be described as Fitzpatrick's ambivalence toward the role of Union Bank is obvious. Although Fitzpatrick had testified during his deposition that he had expected the bank's "stamp of approval" upon any commercial paper he purchased and that he expected all paper shown him by the bank would be "gilt" (see Fitzpatrick, Tr. 130), he recognized by the time of the trial that such reliance upon a sophisticated and knowledgeable bank having access to enormous quantities of information regarding Penn Central was not helpful to his cause. On the other hand, by denying that he relied upon the bank and at the same time acknowledging his own total ignorance of credit matters (Fitzpatrick, Tr. 118), Fitzpatrick rendered incredible the notion that he could have sought or

expected or would have known how to use any information which might have been supplied to him by Goldman, Sachs via Union Bank.

It is submitted that the only credible conclusion to be drawn from Fitzpatrick's testimony is that he was indeed relying upon Union Bank to a substantial degree, and expected Union Bank to make a credit analysis and reach a judgment upon which UHF could rely. In making common cause against Goldman, Sachs, however, Union Bank and UHF found it inexpedient to adhere to that explanation of the transaction, and accordingly contradictions appear from time to time in the record. But these do not undercut the logical conclusion that UHF relied upon Union Bank.

The testimony of Mr. LeMay of Union Bank shows the mirror image of the contradictions contained in the testimony of Fitzpatrick. LeMay adhered, in the main, to the position that the bank was a mere conduit, showing names of available commercial paper to plaintiff. Thus, LeMay testified as follows:

> Q. In the case of purchases for the account of customers as opposed to the bank's own account, did the bank have a judgmental role that it played? In other words, was there any discretion involved in what he purchased?
>
> A. No.

(LeMay, Tr. 57).*

Consistent with his testimony on the Bank's non-judgmental role, LeMay also testified that he passed on to Fitzpatrick all the names that were supplied to him by Goldman, Sachs and other commercial paper dealers:

> Q. . . . My question is whether when you found the names from the commercial paper dealers that fit the maturity and amount requirements did you show all of those names that fit the requirements?
>
> A. Yes.
>
> Q. Did you do that on March 13?
>
> A. Yes.
>
> Q. That was your ordinary practice?
>
> A. Yes.
>
> THE COURT: The more the merrier right?

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* Although he testified he was given no investment criteria by Fitzpatrick (LeMay, Tr. 11-12), LeMay also testified that he did request of Goldman, Sachs that he only be shown paper rated Prime by the National Credit Office ("NCO"). Although Fitzpatrick's testimony as to the meaning of the word "Prime" was internally contradictory, there is absolutely no doubt that LeMay -- the only person who spoke to Goldman, Sachs -- knew that "Prime" referred to the rating of NCO:

> Q. The only meaning in the marketplace that you knew of that prime had in 1969 and the first quarter of 1970 was the rating given commercial paper by NCO?
>
> A. Correct. The name used exclusively by them.

(LeMay, Tr. 61).

THE WITNESS: That is right.

(LeMay, Tr. 64).*

Scattered among the statements cited above indicating that the bank's role was non-judgmental, however, LeMay also attempted to introduce the notion that if unfavorable information came to his attention, it would serve as an "alarm" warning him not to pass on names to customers. (See LeMay, Tr. 34). Upon cross-examination, however, it appeared that as far as the mainstream of commercial paper transactions were concerned, LeMay's remarks were idle speculation because no "alarm" of the type he described had ever come to his attention nor had he ever failed to pass on the name of a prime-rated issuer to UHF or any other bank customer because of an "alarm" which reached him from a dealer or from any other source of information outside the bank:

Q. Let me renew my question as to whether you can give me an example of an alarm

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* LeMay's failure to make any independent investigation or analysis was not the result of lack of sophistication or ability. LeMay has been a banker for 23 years, has taken courses from the American Institute of Banking including courses regarding credit analysis. He had at one time been a licensed stockbroker. During the period 1968 to 1970, LeMay managed the short-term money market operations of the bank including not only commercial paper investments for the bank's own account, but the purchase and sale of certificates of deposit, banker's acceptances, treasury bills and federal agency obligations as well. (LeMay, Tr. 4, 47-50).

that came to your attention from outside the bank other than of a company not rated prime by NCO?

A. No.

Q. No example?

A. No.

Q. To the best of your knowledge, did it ever happen?

A. Not that I know of.

(LeMay, Tr. 46-47).

Indeed, in his testimony regarding Penn Central, LeMay reluctantly admitted that when unfavorable information had come to his attention regarding Penn Central he had not passed it on either to his own credit department or to University Hill Foundation:

Q. Whether or not you recall reading one of the specific [Wall Street Journal] articles, you were generally aware, were you not, that the operating losses of Penn Central were increasing during this period?

A. No, not from that standpoint.

THE COURT: What do you mean not from that standpoint?

THE WITNESS: Not that they were suffering losses to the point of changing their quality rating.

Q. That wasn't the question Mr. LeMay. The question was whether you were aware -- .

A. That was the answer, though.

THE COURT: You want to get back to California, don't you?

THE WITNESS: Alright.

Q. The question is whether you were generally aware at the time that Penn Central was suffering operating losses.

A. Yes, generally.

* * *

Q. Would you characterize the information, just focusing on the headlines of the article[s], would you characterize that as favorable or unfavorable?

A. Unfavorable.

Q. So it was possible that unfavorable information could come to your attention that would not send you running to the Credit Department, is that right?

A. Not in this case, no.

(LeMay, Tr. 77-79).*

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* The fact that LeMay said nothing to UHF regarding the financial condition of Penn Central is established by the testimony of Fitzpatrick:

Q. He said nothing about Penn Central or about any of the other names?

A. No.

Q. And that was his usual practice?

A. Yes.

Q. And you obtained no financial information from Mr. LeMay, is that correct, about Penn Central?

A. That is correct.

(Fitzpatrick, Tr. 121).

Although it is thus readily apparent that the testimony of both LeMay and Fitzpatrick was strained to fit a pattern believed by plaintiff to provide it with an acceptable theory, one simple fact emerges: while Fitzpatrick was relying on LeMay, LeMay was doing nothing.

Goldman, Sachs submits that these facts constitute to a significant degree the circumstances by which the duty of disclosure which fell upon Goldman, Sachs must be defined:

> Disclosure of particular facts was irrelevant to Fitzpatrick because he was relying on LeMay and never had the slightest intention of examining even the most rudimentary information.
>
> Disclosure was irrelevant to LeMay because he viewed himself as a mere conduit of information as to availability of names and at most relied upon the implicit judgment of Goldman, Sachs -- based upon a weighing of all available information, favorable and unfavorable -- that Penn Central was creditworthy.

In short, neither witness gave any credible testimony suggesting that either institution justifiably expected to receive the component data from which Goldman, Sachs reached its own credit judgment.

LeMay's inaction and Fitzpatrick's reliance upon LeMay to the exclusion of Goldman, Sachs are also significant because they demonstrate -- by positive proof -- that plaintiff cannot recover. The element of reliance in actions under Rule 10b-5 -- although it may be presumed in certain circumstances, see, e.g., Affiliated Ute Citizens v. United

States, 406 U.S. 128, 153-54 -- has not been abandoned. Chelsea Associates v. Rapanos, [Current] CCH Fed. Sec. L. Rep. ¶ 95,374, at 98,868-69 (6th Cir. Dec. 11, 1975); Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975); Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1974). See Defendant's Trial Memorandum, at 67-70. The developing case law in this area recognizes that in differing circumstances the burden of proof of reliance or non-reliance may fall upon different parties. In the circumstances of this case involving sophisticated investors, average purchases of $1 million, a dealer as opposed to an auction market and transactions that are essentially face-to-face, defendant submits that reliance is rightly part of plaintiff's case.* Alternatively, however, defendant may in any event defeat plaintiff's cause with

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* REA Express, Inc. v. Interway Corp., CCH Fed. Sec. L. Rep. ¶ 95,421 (S.D.N.Y. Jan. 20, 1976).

> "Plaintiff contends that it need not actually prove it relied on the misleading statements made by [defendant]. The factual situation here involves basically affirmative misrepresentations, as opposed to omissions. We have here face-to-face dealings between sophisticated, well-advised corporate managers, rather than impersonal dealings among investors in an auction market. In this action proof of actual reliance on a false statement is an essential prerequisite to recovery in a Rule 10b-5 claim."

Id. at 99,147.

positive proof of non-reliance,* By either standard, then, plaintiff cannot recover because there is more than positive, there is overwhelming proof that plaintiff placed no reliance on Goldman, Sachs.

Besides his testimony regarding the non-judgmental role of the bank, LeMay also recognized that it was routine for Goldman, Sachs' credit department to make an investigation of an issuer such as Penn Central. (LeMay, Tr. 65-66). LeMay also acknowledged that he knew Goldman, Sachs was collecting information on Penn Central (Tr. 66), and recognized that a credit investigation such as that being conducted with respect to Penn Central ordinarily involved communication with management of the company being investigated. (LeMay, Tr. 67-68).

It is also plain that LeMay knew that Goldman, Sachs' information included more than public information:

> Q. A credit investigation from your experience, does it often [involve] communications with management of a company that is being investigated?
>
> A. It would, yes.

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* E.g., Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1974); Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88 Harv. L. Rev. 584, 587 n.18, 601 et seq. (1975).

Q. That was the ordinary practice?

A. Yes.

Q. Did you assume that Goldman, Sachs had management contacts with Penn Central?

THE COURT: Does he now or did he then?

MR. GRAHAM: Did he.

A. Yes, I would.

Q. And the contents of those management discussions were not communicated to you during your conversation?

A. None whatsoever.

Q. And you never asked for any?

A. No.

Q. Although you assumed they had some?

A. Yes.

(LeMay, Tr. 67-68).

Although it should have been obvious to LeMay that Goldman, Sachs possessed considerable information about Penn Central -- some non-public and some conceivably adverse -- it is thus undisputed that he never asked for such information.

What LeMay expected was that Goldman, Sachs would itself consider all the information, favorable and unfavorable, and reach its own judgment as to whether or not the company was creditworthy:

THE COURT: Would it be too blunt to say that in your mind what was good enough for Goldman, Sachs was good enough for you to pass on to your customers?

THE WITNESS: You are absolutely right, Judge.

(LeMay, Tr. 68). This circumstance too, then, demonstrates that plaintiff and its agent had absolutely no expectation of receiving financial information from Goldman, Sachs apart from a judgment of creditworthiness.

Yet another circumstance which should properly be considered as part of the context in which the expectation of disclosure may be judged is the availability of information within Union Bank. Not only was Fitzpatrick insulated from information which could have been supplied by Goldman, Sachs, but in addition LeMay was insulated by the structure of Union Bank from his own Credit Department which might have provided substantial information, advice and analytic skills had the occasion arisen. By contrast, when the Bank purchased commercial paper for its own account, it had very strict requirements as to what paper could be purchased, and all purchases were controlled by the Senior Loan Committee of the Bank. (LeMay, Tr. 29).

Even within the investment division of which LeMay was a part, moreover, there were available copies

of Moody's Transportation Manual and Standard & Poor's service as well as the supplements to both those compilations of information updating them on a periodic basis. (LeMay, Tr. 82-83). As the testimony of Jack Vogel demonstrates, nearly all of the essential information required to make a full-scale credit analysis is available in Moody's or in Standard & Poor's. (Vogel, Tr. 486-89). In addition, LeMay himself read The Wall Street Journal on a regular basis. The existence of news articles such as Exhibits H, A-182, A-195, A-211, AB, A-180 and A-187 reveal that a constant flow of information about Penn Central appeared in that periodical and was available for anyone who took the trouble to read it.

This memorandum sets forth in Point IV the reasons why knowlege of such publicly available information as was found in The Wall Street Journal and Moody's should be imputed to plaintiff for purposes of this action. But even apart from the question of attribution of knowledge, the very existence of such information in the hands of a trained banker such as LeMay, combined with his utter failure to take advantage of the information or to apply his analytic skills in any manner, is another aspect of the circumstances which should assist the Court in identifying the scope of the duty owed by Goldman, Sachs. Where information of such

magnitude is available and unused, the expectation of the parties making investments is that information about the financial condition of the company in question is unnecessary and irrelevant. See Arber v. Essex Wire Corp., 490 F.2d 414, 419-20 (6th Cir. 1974).

As a corollary to this proposition, moreover, the Court of Appeals for the Second Circuit has recently written,

> "[a defendant's] reasonable belief that the other party already has access to the facts should excuse him from new disclosures which reasonably appear to be repetitive."

Frigitemp Corp. v. Financial Dynamics Fund, 524 F.2d 275, 282 (2d Cir. 1975).

LeMay's testimony about his investment practices, access to financial information on Penn Central, and actual knowledge of its continuing losses (and by inference of its tight cash) has a significant bearing not only on the scope of disclosure expected of Goldman, Sachs under the securities law but also on the extent to which plaintiff met its own duty to investigate.

To the extent plaintiff argues that items of information not communicated to it by Goldman, Sachs but of which it had actual or constructive notice (for example, Penn Central's losses (LeMay, Tr. 78)) were material, its argument proves too much. The Court of Appeals for the Fifth Circuit has approved as representing an accurate statement of the law the following instruction and finding:

> "If you find from the evidence in this case that the plaintiff had knowledge of facts sufficient to excite its inquiry, and that the peculiar circumstances of this case were sufficient to impose upon the plaintiff a duty of reasonable diligence, and that the plaintiff failed to exercise this duty, then you should return a verdict for the defendants."

Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 102 (5th Cir. 1970). See also id. at 104. Thus, if the facts were known to plaintiff -- either actually or constructively -- and if plaintiff now claims they were "material," then they were, or should have been, sufficient to put plaintiff on inquiry notice, and the failure to inquire is a failure to exercise plaintiff's duty of reasonable care:

> "[T]he securities laws are not to be used as an insurance policy for investors who choose voluntarily to disregard facts which would have been uncovered by any reasonable person in their position."

Caan v. Kane-Miller Corp., [Current] CCH Fed. Sec. L. Rep. ¶ 95,446, at 99,242 (S.D.N.Y. Feb. 5, 1976) (Conner, J.). Accord, Eichen v. E. F. Hutton & Co., 402 F. Supp. 823 (S.D. Cal. 1975);* McGraw v. Matthuei, 388 F. Supp. 84 (S.D. Mich.

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* "Where the evidence establishes that plaintiff has both sufficient experience to conduct his own investment affairs and has access to sufficient information to understand the nature of the investment, he has a duty of reasonable diligence which must be exercised to create a right to recover."

402 F. Supp. at 830.

1972).* See also Defendant's Trial Memorandum, at 104-06.

b. The Professionalism of the market as a whole

During 1969 and 1970, the average commercial paper transaction involved the sale of a note or notes having an aggregate face amount of over $1 million. (Van Cleave, Tr. 237). Putting aside all else, the mere size of commercial paper transactions substantially limited the type of investors who had the ability to participate in this market. The nature of that limitation is shown by Exhibit CU which lists all of the entities which purchased Penn Central commercial paper -- either as an investment for that entity itself or for the account of a usually undisclosed customer. The exhibit shows that banks, mutual funds, pension funds, major industrial corporations and insurance companies account for the vast bulk of all sales. It also appears from an examination of the face amount of paper purchased that the large banks and mutual funds predominate in terms of total face amount purchased as well as in total number of transactions.

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* "An investor who casually makes investments, and who blindly rides bubbles until they burst, does so at his own risk, and cannot later invoke § 10(b) as a form of 'investor's insurance'."

388 F. Supp. at 92.

On the date of discount and delivery of the UHF note, for example, Exhibit CU shows, typically, that the only purchasers of Penn Central paper were a well-known mutual fund which acquired $5 million face amount of notes and six banks (including Union Bank), each of which made investments in notes having face amounts ranging from $300,000 to $2 million.* Institutions of this type are highly sophisticated investors -- in terms of professional skill, access to information and ability to determine what investigation or analysis, if any, should be made.

The obvious reason why the commercial paper market is dominated by substantial institutional investors is that it offers a significant advantage only to those with very large sums of money to invest at a time. Exhibit CL shows that, in the ordinary course, commercial paper rates are only fractionally higher than rates available on certificates of deposit, Treasury bills and other money market instruments. That differential is of significance in investments averaging thirty to sixty days only if the sums involved are very large. The testimony shows that it is ordinarily the professional money manager who has such

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* Two of the six banks (Mellon Bank and Marine Midland Bank) had significant lending relationships with Penn Central as well as a history of other relationships with the Railroad. See Ex. BY and Ex. A-21, at 4 (interlocking directorates).

sums to invest and is prepared to take the additional risk entailed thereby. (Van Cleave, Tr. 237).

Goldman, Sachs, of course, does not contend that the professional money manager is not entitled to the protection of the securities law. It does submit, however, that the obligations of a seller of securities who deals with professionals is somewhat different from the obligation of one who deals with the occasional investor who lacks adequate background and independent access to relevant information. For example, while the average equity investor may well not have immediate access to statistical and financial manuals, Union Bank subscribed both to Moody's upon which Vogel principally relied, and to Standard & Poor's service.* (LeMay, Tr. 82-83).

This position finds recent support in Caan v. Kane-Miller Corp., [Current] CCH Fed. Sec. L. Rep. ¶ 95,446 (S.D.N.Y. Feb. 5, 1975):

> "Although 'sophisticated investors, like all others, are entitled to the truth,' Stier v. Smith, 473 F.2d 1205, 1207 (5th Cir. 1973),

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* For this reason, cases referring to the equity and bond markets which involve different kinds of investors with substantially different expectations are not here in point. Because investors in the circumstances presented in other cases may have had an insufficient basis for determining whether or not to ask for additional information, courts have, on occasion, protected them by imposing liability even if information was not sought by the investor-plaintiff.

> the claimant's sophistication, expertise and business acumen, its access to information and opportunity to detect the alleged fraud are all relevant considerations in determining the exercise of reasonable diligence."

Id. at 99,242.

As previously shown, LeMay's practice was not to conduct an investigation or analysis, although he admitted that he did have a general awareness of the continuing losses of Penn Central during this period (LeMay, Tr. 78), and had access to his own credit department as well as the financial manuals described above.

LeMay's position in this regard was neither unusual nor unreasonable considering the nature of the professional market. Many professional investors, assessing the commercial paper market as a whole, determined that a rating of Prime and the offering of the paper in question by a reputable commercial paper dealer were a sufficient basis for investment. Because Goldman, Sachs made a thorough and careful credit analysis and consistently and uniformly adhered to a policy of selling only commercial paper it believed creditworthy (see Point III, infra), such a practice by professional investors was entirely appropriate. The decision to proceed in that fashion was -- like virtually every decision made by investors in the commercial paper market -- a professional one based upon a knowledgeable

assessment of the operation of the market, the practices of commercial paper dealers and the risks involved in proceeding in the manner chosen.

It should be noted in this regard that not all commercial paper investors take the approach adopted by LeMay on behalf of UHF. Some make a complete credit analysis similar to that performed by Goldman, Sachs itself. Manufacturers Hanover Trust Company, for example, maintained an approved list of commercial paper issuers (Ex. FF) which was prepared in consultation with the bank officers having regular contact with the issuers in question. (Sullivan, FSB Tr. 882-84) That list was then used as a guide in the case of purchases by the bank for its customers. In other words, unlike Union Bank, some banks were as careful with their customers' money as with their own. (Compare Sullivan, FSB Tr. 880-84, with LeMay, Tr. 29).

LeMay -- like many other professionals in his position -- had the background, training and access to information that would have allowed him, if he had so chosen, to make an independent credit analysis or to require that one be done within Union Bank. It can only be concluded, therefore, that after comparing the risk of relying upon Goldman, Sachs' judgment with the cost of making an independent judgment, LeMay chose the former. He failed of course to inform UHF

of this decision, and UHF continued to rely upon him to make a credit judgment. (Fitzpatrick, Tr. 130). That failure of communication cannot now be blamed upon Goldman, Sachs, however, and UHF is bound by the decision of LeMay and Union Bank not to seek information or to conduct any independent investigation or analysis. Accordingly, UHF should not be allowed, with the benefit of hindsight, to claim that it should recover here because if LeMay had made some other choice he might have been entitled to some form of disclosure other than that which he received.

c. The practicalities of disclosure in this market.

The testimony of Van Cleave shows that the commercial paper selling day is necessarily limited to approximately three hours in the morning of each day. (Van Cleave, Tr. 272-74; see PX-75, at 5). The reason for this compressed schedule is the desire of nearly all investors to purchase their paper for same-day delivery so that they may begin to earn interest at once. (Van Cleave, Tr. 261). To achieve this result all paper work necessary to the completion of the transaction as well as the physical delivery of notes must be completed before 3 o'clock in the afternoon New York time when banks close. Accordingly most selling is done in this busy morning period. (Van Cleave, Tr.

267). As the Court recognized during trial, "when you handle 400 transactions a day, obviously, by definition, time is even rarer than money, you can't spend very much time on each telephone call." (Tr. 260).

The practicalities of the market affect the investor as well as the dealer. LeMay testified on direct examination that his calls made in connection with commercial paper transactions are invariably brief and necessarily uninformative. (LeMay, Tr. 12-13, 34-35, 62). Although his time estimates were somewhat variable LeMay stated that he often had as many as 105 conversations during a three hour selling day and also testified that his typical conversation with Goldman, Sachs was "[n]o more than half a minute or longer to recite what is necessary." (LeMay, Tr. 62).

Such brevity is required in order that Goldman, Sachs and the other dealers may serve the needs of many investors during the compressed selling day in which hundreds of millions of dollars of commercial paper is sold. On the delivery date of the UHF notes, the total maturities of all issuers -- which is an approximate measure of the face amount of paper to be sold that day -- exceeded $308,000,000. (Exhibit CU). Obviously salesmen charged with responsibility for making that many sales in a very short period of time cannot possibly pause to discuss

with every investor the financial condition of each issuer whose paper is offered. And this fact too is known to the professional investor who participates in this market.

Prior to the Penn Central purchase, Union Bank had purchased paper on numerous occasions from Goldman, Sachs as well as other dealers. (LeMay, Tr. 14-15). And it is undisputed that the previous transactions had occurred in the course of very brief telephone conversations in which only maturities, amounts, availability and rate were discussed. (See LeMay, Tr. 63-64). LeMay certainly had no reason to believe that the call here in issue would be different. Accordingly, it was his expectation that unless he asked for it he would not be given information in the routine telephone call during which he purchased commercial paper.

Knowing that Goldman, Sachs had substantial additional information at its disposal, LeMay nevertheless chose to make absolutely no inquiry, investigation or analysis either through Goldman, Sachs or on his own.

In the instant transaction, then, no false statement was made and no statement of any kind was made which was rendered misleading by virtue of any omitted fact. The sole statement of substance made was the implied statement that Penn Central was, in Goldman, Sachs' opinion, creditworthy. Plaintiff has not offered any explanation of how

that statement of opinion -- which was complete and self-contained -- could be rendered misleading by any non-communicated fact. And indeed it is difficult to conjure up such a fact unless -- as will be shown not to be the case here -- the opinion rendered was itself unreasonably held. No isolated fact renders an opinion misleading unless the fact is one which should change the opinion and therefore renders continued adherence to it unreasonable.

Accordingly, the dispositive issue in this case is whether there was a reasonable basis for Goldman, Sachs' implied opinion of creditworthiness. That issue is considered in the next section of this memorandum.

III. GOLDMAN, SACHS HAD A REASONABLE BASIS FOR ITS JUDGMENT THAT PENN CENTRAL AT ALL MATERIAL TIMES WAS CREDITWORTHY

Apart from the issue of good faith, the critical question in this case is whether Goldman, Sachs had a reasonable basis for its judgment on March 13, 1970 that Penn Central was creditworthy.* The trial evidence reveals that at all times during the sale of Penn Central commercial paper up to and including UHF's March 13, 1970 purchase, Goldman, Sachs reasonably held the view that Penn Central had sufficient cash or access to cash from which to pay the commercial paper as it came due. (Vogel, Tr. 483, 548-49, 554, 555).

The first part of this section will review the steps actually taken by Jack Vogel after learning of Penn Central's preliminary 1969 earnings in assessing the financial strength of Penn Central and its affiliated companies.

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* "Q. Mr. Wilson, what is your definition of the word 'creditworthy?'

A. Creditworthy as we use it at Goldman, Sachs and in the commercial paper department at Goldman, Sachs is the capacity of an issuer to meet its short-term obligations, meaning commercial paper maturity, bank debt, other short-term debt that would become due, meet it on time, the analysis that would go into it to make us satisfied that there was cash or the equivalent available to pay those notes on time."

(Wilson, Tr. 851).

questions that arose during the continuing communication between Penn Central and Goldman, Sachs -- all part of Goldman, Sachs' ongoing credit evaluation -- did not adversely affect Goldman, Sachs' reasonable basis for the judgment that Penn Central was creditworthy. The second part of this section will establish the reasonableness of the operation and procedures of Goldman, Sachs' Credit Department as described in Defendants' Trial Memorandum (at 9-13).

A. Goldman, Sachs' Reasonable Basis

On February 6, 1970, David Bevan, Chairman of the Finance Committee of Penn Central, and Jonathan O'Herron, financial vice president, met with Gustave L. Levy and Robert G. Wilson to discuss the financial prospects and financing plans of Penn Central. This meeting began with the discussion of the $56 million operating loss of the transportation company which Bevan "did a thorough job of explaining." (Ex. PX-12 (A-69)). Although this loss was substantial, Wilson did not consider it troublesome when viewed in light of Penn Central's consolidated earnings, its strong asset structure, and management's plans for 1970. (E.g., Wilson, Tr. 892-93).

Included in Bevan's explanation of the 1969 year-end results was the management's projections for 1970. Bevan predicted that the railroad's losses would be $56 million and that the holding company would produce a $20-25 million

profit in 1970. Both pieces of information had a positive influence on Wilson's assessment of Penn Central's creditworthiness. The $56 million predicted yearly loss for 1970 was actually favorable news because of Penn Central's history of declining earnings.* At last, the railroad's yearly losses had reached bottom.

The trend of railroad earnings had for several years steadily worsened, as anticipated in the financial community, while the two railroads were being merged to realize economies. What Bevan stated on February 6, 1976, was that operating railroad losses in 1970 were not going to get any worse, but that they were going to be the same in 1970 as in 1969. (Wilson, Tr. 891-92, 993-94; Levy, Tr. 761). Furthermore, the holding company was able to earn only $4 million in 1969, but in February, 1970, its chief financial officer was predicting that consolidated earnings for 1970 would be five to six times as great.

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* See Graph of Penn Central Earnings, at 192 infra.

Although Jack Vogel testified that he did not attend the February 6 meeting, he did receive the blue sheet, Exhibit PX-12 (A-69), describing what transpired, and used the information obtained in his continuing analysis (Vogel, Tr. 543-44):

"Q. After reading and reviewing this blue sheet, did you do anything?

(Footnote continued on next page)

Even apart from the positive aspects of the earnings situation described by Bevan, Vogel's uncontradicted testimony regarding appropriate methods of making a commercial paper credit analysis shows that earnings are substantially less important to a commercial paper credit analysis than a number of other factors which relate to the asset structure and available sources of cash of the company in question, and that there are substantial distinctions between credit analysis and equity analysis.

Of course, in the long run substantial losses may erode a balance sheet to the point where the credit of the company comes into doubt. Similarly, losses without any prospect of improvement over time indicate a credit problem in the future. Where, however, the assets were so enormous that

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(Footnote cont'd)

* * *

"A. Yes. In context with my continuing review of the railroad and the various assets and et cetera, I used that information which was developed at that luncheon meeting in terms of expected expenditures and fund raising programs and so forth as additional facts to be considered within the context of my analysis.

"I thought it was a very positive meeting in that it developed information which I was able to use and which didn't lead me to believe in any way that they weren't able to do it or that it wasn't a viable program."

(Vogel, Tr. 544-45).

the erosion from quarterly losses was comparatively small, and where it was universally and reasonably believed on the basis of substantial information that the long-term prospects of the company remained excellent (see Levy, 760-61), the results of a single quarter were of minor significance to a commercial paper credit analysis. (See Wilson, Tr. 854-56).

But Vogel well knew that a $56 million loss even in a company with $6 billion of assets was not something that could be dismissed without further inquiry. Therefore, he conducted a review of what he called the "cushion," namely some -- but by no means all -- of the assets in the Penn Central system to determine if their value was substantially in excess of Penn Central's debt. (E.g., Vogel, Tr. 552).

At trial, Vogel explained his review and how it was he could reach the opinion that Penn Central, on a consolidated basis, was creditworthy.

"Q. Based on the information that you reviewed, on what basis did you conclude that Penn Central was creditworthy?

* * *

"A. By analysis of all the material that I referred to earlier indicated to me Penn Central had the wherewithal to meet their upcoming obligations, and so I concluded it was creditworthy.

"Q. What was this wherewithal they had?

"A. Again, we are talking about a railroad that had total assets somewhere in the

> neighborhood of $6 billion worth of assets on their balance sheet, a net worth of approximately, as I recall it, 3 billion, investments in companies, for example, like the Pennsylvania Company, which in turn had investments in a number of companies, Buckeye Pipe Line, Arvida, Great Southwest. They had a lot of stock in the Norfolk and Western Railroad. They had a couple of small railroads, D.T. & I., as I recall, was one. The Penn Central Company itself also had investments in the Pittsburgh and Lake Erie. They had what I consider to be a substantial amount of real estate. There are reports about real estate being developed in Washington and we all know about the New York real estate, Madison Square Garden and the hotels they owned and so forth.
>
> "So that I felt that their real estate had a substantial value unrelated to the existing investments.
>
> "So given a combination of all those factors, among other things they had just arranged $100 million worth of bank credit and some stand-by lines, $50 million worth of stand-by lines to cover the paper, that they had sufficient wherewithal, alternate sources of cash, if you will,to meet their on-going obligations in the foreseeable future."

(Vogel, Tr. 493-94; see also id. 548-54). Of course, in his credit analysis Vogel was quite careful "if there were any encumbrances or any pledges, or whatever [to] deduct from those values whatever the encumbrances or pledges or whatever was." (Vogel, Tr. 505; see also id. 495-96, 550, 552).

Vogel focused on the consolidated company because "it represented the totality of the Penn Central complex."

(Vogel, Tr. 495). In other words, in a system of companies such as Penn Central, assets could be moved from company to company and earnings from either direct or indirect subsidiaries were available to the parent transportation company. (Tr. 669-700). Moreover, Vogel, and indeed the entire investment banking community, knew that the railroad operations were habitually in the red as a result of deficit-producing passenger service. (E.g., Ex. A-210). For years Penn Central had tried to obtain government subsidies of its passenger operations or direct government takeover of those operations. (E.g., Ex. A-188). Penn Central's investment strategy was to acquire non-railroad companies to use their earnings to offset the losses from railroad operations; and the real strength of the Penn Central system lay in its non-railroad subsidies. (See Vogel, Tr. 668; Wilson, Tr. 860-61).

The result of Vogel's study, conducted in the days and weeks after the February 6 meeting and updated on a regular basis up to and including the date of UHF's purchase on March 13, 1970, was that Penn Central had readily identifiable more than $600 million in assets in excess of all debt on those assets. Vogel reasonably concluded that $600 million of assets which could be pledged, sold, or hypothecated in order to raise cash to meet commercial obligations coming due was an adequate cushion so that Goldman, Sachs could continue to sell Penn Central's commercial paper.

In carrying out his analysis, Vogel did not reduce to writing his thinking and figuring. (Vogel, Tr. 505-06). Rather, like a person with a substantial balance in his checking account, but who has not recently balanced his checkbook, Vogel reviewed the assets of Penn Central to see if their rounded-off value would enable him to write another check without overdrawing the account. Having concluded that he need not worry, Vogel did not reduce precise figures to writing to get a specific balance.

The tools of the February and March credit study included Penn Central's February 4 press release (Ex. A-24), the $50 million debenture offering circular (Ex. A-12), the April 10, 1969 Penn Central Company notice of annual meeting and election (Ex. A-17), and 1969 Moody's Transportation Manual (Ex. AM-3). These documents contained abundant financial information about Penn Central and its subsidiaries and enabled Vogel to determine -- without viewing the assets of more than 10 or 12 companies -- that Penn Central had a substantial cushion.*

Vogel's study was built upon his knowledge of Penn Central from the summer of 1968 when he conducted 95% of Goldman, Sachs' initial credit investigation of this issuer.

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* Appendix A to this memorandum sets forth the specific assets reviewed and how their values are determined from data in evidence.

(Vogel, Tr. 477-78, 556-57). He was familiar with the companies in the Penn Central system and was familiar with their financial condition. On the basis of his earlier reviews, Vogel, like the rest of the investment banking community, had reached the conclusion that Penn Central was a unique credit primarily because of the strength of its assets.

The reason Penn Central was perceived as being different resulted from its tremendous size. After the United States Supreme Court approved the merger of The Pennsylvania Railroad Company and The New York Central Railroad Company, the merged company was "a huge combination of two railroads." (Vogel, Tr. 477-78).* In fact, the combined railroads were the largest transportation company in the world. Assets of $6 billion,** operations in numerous states*** involving thousands of miles of track,**** and tremendous real estate

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* Exhibit A-335, the June 10, 1966 Proxy Statement of the New York Central System discloses that at the time the Central was this nation's third largest (at 12), the Pennsylvania the largest (at 14) railroads in terms of total operating revenues.

** 1968 Moody's Transportation Manual at 425, (Ex. AM-2).

*** The merged railroads operated in 14 states, the District of Columbia and the Canadian provinces of Quebec and Ontario. Id. 417.

**** "As of Dec. 31, 1967 total miles of road operated by Penn Central system consisted of 19,177.35 miles and total miles of all tracks operated consisted of 40,322.92 miles." Id. 417.

holdings* all ensured that Penn Central was perceived in the financial community as unique. (See generally Vogel, Tr. 477-78). Years of scrutiny by the Interstate Commerce Commission and the federal courts meant that only after every event, plan or contingency involved in the merger had been considered was the final judgment reached: the merger was in the public interest. This scrutiny by federal agencies and courts was an added indicium of creditworthiness.

The railroad also owned considerable non-railroad operations that were consistently profitable and contributed to consolidated earnings. Even though the railroad operations had been losing money and were expected to continue to lose money, members of the financial community were willing to extend credit to Penn Central because everyone agreed that it would take years to realize the economies from the merger. (LeMay, Tr. 73, 95).**

The amount of commercial paper that was to be outstanding at any one time was also insignificant compared to Penn Central's assets. (Vogel, Tr. 493-94; Wilson, Tr. 856-57, 859-60). Commercial paper outstandings grew from $100

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* See id. 416-417.

** (See also, Corrigan Dep. 15-16). John E. Corrigan was the financial officer at The First National Bank of Chicago with responsibility in 1969 and 1970 for loans to transportation companies, including Penn Central. (Id. 3-6).

million initially to $150 million in the spring of 1969 and then to $200 million. During this time period, not only were the available assets within the Penn Central substantially in excess of the outstandings, but even accounts receivable alone were greater than the amount of commercial paper outstanding. (Wilson, Tr. 850-51; Ex. A-21, at 27).

Contacts with Penn Central

During 1969 and 1970, Goldman, Sachs as part of its ongoing credit investigation maintained contact on a regular basis with Penn Central. These contacts by and large appear in "blue sheets," internal Goldman, Sachs memorandum recording meetings with issuers and written to inform other personnel of Goldman, Sachs of those meetings. Plaintiff removes certain facts recorded in these blue sheets -- for instance, the existence of a "tight cash" situation at the Railroad, the related problem of poor earnings, and discussions about standby and swing lines -- from their context and asserts that these facts, independently or alone, render unreasonable Goldman, Sachs' judgment that Penn Central was creditworthy. A detailed review of the subjects covered in the meetings recorded in the blue sheets shows otherwise.

Opinion of Management

No fact is more important, as LeMay properly recognized (LeMay, Tr. 67-68), than a positive opinion of the

issuer's management. For all the work done in Goldman, Sachs' Credit Department, an essential element of Goldman, Sachs' credit judgment was based upon the contacts with officials of Penn Central. The work which Vogel performed was the bedrock of the credit judgment; without Goldman, Sachs being satisfied that Penn Central had sufficient usable assets to employ to meet its commercial paper obligations as they came due, no amount of confidence in the management of an issuer or a potential issuer could produce a conclusion of creditworthiness. Conversely, even if Goldman, Sachs were satisfied that an issuer had usable assets, if it were not convinced that the management of that issuer was capable and honest then it would not reach the view that that issuer was creditworthy. For it makes no difference how many assets a company has, if its management is incapable or unwilling to use those assets prudently.*

The evidence at trial is overwhelming that in 1968, 1969 and 1970, Goldman, Sachs (Levy, Tr. 748-53; Wilson, Tr.

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* The testimony of John J. Sullivan, Senior Vice President of Manufacturers Hanover Trust Company ("MHT"), also plainly demonstrates the reasonableness of premising a judgment of creditworthiness upon the financial institutions' estimate of management. On June 21, 1970, MHT had outstanding to Penn Central $45 million in loans. The credit investigation conducted by MHT paralleled that of Goldman, Sachs, especially in regard to the reliance on one's assessment of management. (Sullivan, Tr. 844-45, 875-76).

853-54), and indeed the entire financial and business community, were of the opinion that Penn Central management were highly qualified businessmen of integrity. (See, e.g., Exs. A-76 and A-104). And the testimony of John J. Sullivan, Senior Vice President of Manufacturers Hanover Trust Company, confirms that Bevan, O'Herron and Loder had at all material times excellent reputations for ability and integrity. (Sullivan, Tr. 874-75). They had been chosen specially for the formidable task of realizing the economies from the merger of the New York Central and the Pennsylvania Railroad. Indeed, Sullivan testified that "from their [Bevan's, O'Herron's, and Loder's] background and actions and from their dealings with our bank, we considered them to be eminently qualified for the job that they were doing." (Sullivan, Tr. 875).

Plaintiff has offered no evidence in this case that would cast doubt on the reasonableness of such an opinion -- based upon then current information -- in 1969 and 1970. The evidence, on the contrary, has shown that management always was able to effect the financings and accomplish the other business plans that had been discussed with Goldman, Sachs. Questions asked during meetings between Goldman, Sachs and Penn Central were answered forthrightly and completely. It is against this background of confidence in

the managers of Penn Central that questions raised in meetings between Goldman, Sachs and Penn Central must be considered.

Bank Lines

One of the subjects that was often considered in late 1969 and the first half of 1970 was whether Penn Central would obtain 100% line coverage. It is useful to preface this discussion with a brief review of the type of lines available to and actually used by Penn Central.

A revolving credit agreement is a written arrangement by which a group of banks undertakes to lend a given amount of money upon request. (See Sullivan, FSB Tr. 848-50). Ordinarily the agreement provides that the money may be repaid and reborrowed at any time ("from time to time") during the life of the agreement. (Ex. B-19, Section 1.01). It may also provide for conversion to a term loan at the end of the revolving period. (Id. Sections 1.03, 1.04).

In 1970 Penn Central had a $300 million revolving credit agreement which had been arranged in April of 1969. (Ex. B-19). By the time of UHF's purchase, $250 million of that $300 million had been drawn down by Penn Central, with the remaining $50 million specifically allocated as "backup" for commercial paper. This allocation was not a form of legal security for commercial paper holders, and there was

nothing in the revolving credit agreement binding Penn Central to use any portion of the funds for any particular purpose. (Ex. A-17, at 11). Nevertheless Penn Central had undertaken to hold that money available as a means of raising cash in the event of a commercial paper runoff, and its total borrowing limits set by the I.C.C. took account of this fact. (See Ex. PX-64).

Penn Central also had $50 million in backup lines or bank lines available during most of the relevant period. Although a backup line is also an expression of willingness by a bank to lend money in certain circumstances, unlike a revolving credit agreement it is not a formal contractual arrangement. It is created on the understanding that actual cash will be made available to the borrower only in the event that, at the time the money is requested, the lender continues to be satisfied with the financial condition of the borrower. (LeMay, Tr. 55-56; Van Cleave, Tr. 305; Vogel, Tr. 513; Sullivan, Tr. 876-77). This proviso means that backup lines for commercial paper were by no means security for commercial paper investors: the very events which might cause an issuer to be unable to pay its commercial paper would be those which would induce banks not to lend money on the basis of existing and unused lines. (LeMay, Tr. 55-57).

As Vogel explained during trial:

"THE WITNESS: . . .

If a company is not going to meet its obligation, it doesn't make a particle of difference how many bank lines it has. They're really not from a credit point of view that significant. It's important as an expression of a bank's willingness to lend, but it's not material or relevant to the creditworthiness of the company.

THE COURT: I want to be sure I understand this because it's kind of esoteric to a non-credit man and it's important in the case.

Are you saying that it isn't very important with regard to the commercial paper whether there were additional bank lines because the bank lines wouldn't mean anything in the crunch, if it came to a crunch, and the issuer couldn't pay the commercial paper?

THE WITNESS: I'm saying that if circumstances were such that the company's ability to meet its on-coming obligations had so deteriorated by virtue of whatever circumstance, that their only alternative to meet that commercial paper was to go into the banks, borrow under the lines of credit, who were also looking at the same sets of circumstances, indicating that deterioration, that at that point of time there isn't a banker that I know of would put good money after bad."

(Vogel, Tr. 512-13). Indeed, in the late spring of 1970 when most of Penn Central's backup lines were used, two banks (with $3.5 of lines) declined to participate, and their promised funds were never received by Penn Central. (Lepley Dep. 33).

The other banks did participate, which shows merely that they continued to be satisfied with the financial condition of the issuer. (Ex. BY; see Sullivan, FSB Tr. 846-49).

The evidence also shows that Penn Central converted some of its backup lines to "swing lines." Swing lines are lines of credit available for use on a daily basis and may be used, repaid and used again on a few hours notice. Unlike backup lines, swing lines are arranged on the expectation that they will be used in the immediate future and on very short notice, and accordingly are useful as a daily supplement or substitute for a commercial paper dealer's inventory. (Van Cleave, Tr. 296). Like backup lines, swing lines are subject to the condition that the lender continue to be satisfied with the borrower's financial condition at the time the lines are used.*

Both bank lines and swing lines -- even when unused -- are not gratuitous promises on the part of the bank. All lines are paid for either by specific cash payments or by the maintenance of compensating balances or by both. The revolving credit agreement provided for payments of one quarter of one

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* This fact is reflected in Exhibit BZ which embodies a swing line arrangement between Penn Central and First National Bank of Chicago. The letter agreement specifically provides that loans under the swing line "may be terminated at any time by either of us by written notice to the other. . . ." (See also Van Cleave, Tr. 305, 418-20).

percent per annum on the unused balance of the lines. (Ex. B-19, Section 1.06). Backup lines are ordinarily granted on the understanding that the potential borrower will maintain compensating balances of 10% of the unused portion of the line; and swinglines often require a 20% balance. (Van Cleave, Tr. 246-47).*

Bank lines were first seriously discussed during September 11 meeting called by Wilson to discuss "Penn Central's short-term borrowing needs in the near future and to discuss increasing commercial paper to $200MM from the current $150MM level." (Ex. PX-20 (A-90)). Wilson then explained to O'Herron that certain of Goldman, Sachs' commercial paper customers had an arbitrary criterion for purchasing paper that the issuer have 100% bank line coverage. At that time, Penn Central had bank lines covering 50% of its outstanding commercial paper. Wilson inquired whether Penn Central could obtain additional lines, and O'Herron responded that he could but

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* A compensating balance is money kept on deposit in a non-interest bearing account. The cost of maintaining a compensating balance may be calculated by reference to the interest that would have been earned on such cash if it were otherwise invested or by the cost of arranging loans which would not be necessary if the compensating balances could be used. To obtain an additional $100 million in backup lines Penn Central would have been required to deposit approximately $10 million in non-interest bearing accounts. On an annual basis at the prime rate during early 1970 this would have amounted to a cost of $850,000. (See Ex. CL)

would prefer not to do so. Wilson obviously construed O'Herron's expressed preference as based on the cost of additional bank lines and his view that Penn Central's access to credit, its $240 million in receivables and its investments in various securities capable of liquidation in an emergency were "factors [which] should be considered in lieu of increasing bank lines." (Ex. PX-20 (A-90); see Wilson, Tr. 850-51)

The topic of bank lines was again taken up at the February 6 meeting. Wilson knew from his experience that despite Penn Central's vast assets, the market might react spontaneously to the announcement of Penn Central's year-end earnings and might not be as enthusiastic as before in buying its commercial paper.* To avoid any temporary market

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* Wilson, however, was mistaken in his apprehension of a run-off, as he testified at trial:

> "THE WITNESS [Wilson]: I was wrong, that the outstandings did not run off as I had thought they would over the next 30 days. There are other changes that went on in here, and I am speaking now of getting the railroad to set up some swing lines, and our reducing this amount we were carrying in inventory turned out exactly to be what we were telling them all along, it was going to become a more efficient way of selling paper, the investor could choose his maturity every day. So the outstandings were approximately 200 million about this time on February 5, and my recollection is that they remained at that level for the next sixty or ninety days. So I can't testify and tell you that all investors that had Penn Central on the approved list kept it on the approved list because I don't think they did, but I can't quantify it for you. The end result was that we were able to keep the outstandings pretty much at the $200 million level."

(Wilson, Tr. 890-91).

imbalances in the supply and demand of Penn Central commercial paper, Wilson again suggested to O'Herron that Penn Central obtain additional standby lines. O'Herron was still unwilling for Penn Central to incur the costs, but instead preferred that these costs in effect be borne by Goldman, Sachs. (Ex. PX-11 (A-71))

Although both Bevan and O'Herron said they questioned whether the Railroad could obtain an additional $100 million in standby lines at that time, believed that these statements merely reflected a continued unwillingness to incur the cost of obtaining lines:

> "A [Wilson]. I don't think they wanted to pay the cost of it. Their compensating balances and the other costs related to bank lines and activating bank lines, I think they were very happy letting Goldman, Sachs carry the unsold portions in our inventory. So I don't think John wanted to do it, neither John O'Herron nor Dave Bevan wanted to do it. I think they could have done it.

(Wilson, Tr. 894; see Van Cleave, Tr. 312). Wilson noted that the Penn Central officials did not say that they had gone to a bank and been turned down for a line of credit (Wilson, Tr. 895-96), but rather that they said they had concluded based on the generally tight money market that existed in early 1970, that it would be difficult for Penn

Central to obtain bank lines. (Id.). Wilson disagreed. (Id. 894).

Penn Central's preference not to increase bank lines did not shake Goldman, Sachs' judgment that Penn Central was creditworthy. First, Goldman Sachs' suggestion that bank line coverage be increased to 100% was based upon an assessment of technical market conditions. (Van Cleave, Tr. 404). The undisputed testimony at trial shows that bank lines were one of several arbitrary criteria used by commercial paper investors, particularly non-bank investors, in lieu of an in-depth credit analysis, and one that had no necessary correlation to the creditworthiness of an issuer. (Wilson, Tr. 867-68; Vogel, Tr. 511-12).

Second, bank lines were useful only to handle short-term market fluctuations, or as Mr. LeMay put it, "last moment" daily needs. (LeMay, Tr. 97). If there were going to be serious financial difficulty at Penn Central, then bank lines would not help. (LeMay, Tr. 55-57).

Third, Goldman, Sachs knew from its own experience that bank lines, although only an indication of willingness on the part of the bank to lend in the future,* are normally granted only if a commitment fee is paid or if the potential borrower will maintain "compensating balances" with the bank

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* (LeMay, Tr. 55-57; see Doty, Tr. 686-87).

extending the line at no interest. (E.g., Van Cleave, Tr. 246-47). Accordingly, Goldman, Sachs understood O'Herron's tactic to be a means of avoiding substantial transaction costs that, in his view, were not necessary to market the paper. (Wilson, Tr. 894; Van Cleave, Tr. 312). Finally, the credit analysis performed by the Credit Department confirmed that Penn Central had access to cash and assets, including but not limited to the assets mentioned by O'Herron during the September 11 meeting.

Related to the subject of 100% line coverage were attempts by Goldman, Sachs to convince Penn Central to convert some of its back-up lines into swing lines. These discussions first began in November and December 1969 (Exs. PX-30 (A-78) and PX-22 (A-79)), and lasted until February 1970, when Penn Central did in fact convert some of tis backup lines. Penn Central's reaction to Goldman, Sachs' advice to obtain swing lines was consistent with the railroad's position on increasing bank lines. As Van Cleave testified:

> "THE WITNESS [Van Cleave]: The advice was to follow our suggestion of establishing swing lines and allowing us to sell against order and let them use those swing lines instead of our financing, doing the financing for them.
>
> THE COURT: Did they state why they didn't do so?

THE WITNESS: It was expensive.

THE COURT: Somebody had to take the rap on it, either you or the banks?

THE WITNESS: Or them. Better us than themselves. . . .

(Van Cleave, Tr. 312).

Swing lines are relevant to a judgment of creditworthiness for only one reason. Because used immediately, swing lines necessarily represent a more current view of a bank's opinion of the creditworthiness of the borrower than does the existence of an unused standby or back-up line. Therefore, the ability to obtain swing lines in February of 1970 provided additional assurance of Penn Central's creditworthiness.

Tight Cash

A theme that was first taken up at the September 11 meeting and carried over to the early February discussion was that Penn Central "will be in a very tight cash position in the first quarter of 1970 . . . ." (Ex. PX-20 (A-90)). Of course, in the same breath that O'Herron or Bevan spoke of Penn Central's "tight cash" or other "various financial woes" they also mentioned planned financings and other "potential cures" for those woes.

That Penn Central would be in a tight cash position in the first quarter of 1970 did not affect Goldman, Sachs' judgment of creditworthiness. At trial Wilson explained:

"Q. Did Mr. O'Herron's reference to tight cash in the first quarter have any significance from the standpoint of credit in your mind?

A. No, it did not.

Q. Why not?

A. For several reasons. One, I had known from the discussions I had had with the managements of the two predecessor railroads that the first quarter of a calendar year for both railroads were the ones where their earnings were the lowest of the four quarters of a year and was a time when, from a cash point of view, with the Penn Central Company, that the non-railroad earnings were less than other quarters during this first quarter. So telling me that he was going to be in a tight position was really confirming or telling me something I knew historically with the two predecessor railroads and with this railroad; and the last point I would make on this is the fact that it was tight cash certainly never meant to me that they were running out of cash to the point that it couldn't be replenished. It just means that their cash balances were down."

(Wilson, Tr. 862-63).

In short, being tight for cash is not the same as being out of cash, and moreover, O'Herron's statement that Penn Central would be in a tight cash position in the first quarter of 1970 came as no surprise. It is well-documented that railroads operating in the Northeast have historically had poor first quarter results, primarily caused by severe winter weather. (Wilson, Tr. 878, 1023-24). For the Pennsylvania

Railroad in the period 1958 to 1967, the ten-year average of first quarter net railway operating income contributed only 3.94% of year-end income. (Ex. AM-2, 1968 Moody's Transportation Manual at 422). The figures for the New York Central were even worse. On the average, first quarter net railway operating income for the ten-year period 1958 to 1967 contributed only 3.05% of the ten-year average total net railway operating income. (Id. 447). To say that the successor railroad of these two corporations* would be in a tight cash position for the first quarter of 1970 was only to state the obvious.

The very need for commercial paper indicated to Goldman, Sachs that Penn Central, like every other issuer of commercial paper, had certain requirements, including seasonal requirements, for cash. (Vogel, Tr. 520-22). Although plaintiff has alleged that the existence of a "tight cash" situation at the Railroad was in fact adverse to a positive view of creditworthiness, plaintiff has not in any sense explained why this should be so. The evidence, on the other hand, shows that at all times up to March 13, 1970, Penn Central had access to credit.

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* Although by September 1968 (the date of publication of the 1968 Moody's Transportation Manual), the two railroads had been merged, Moody's reported certain statistics separately. (See also Ex. AM-3, 1969 Moody's Transportation Manual at 172).

When Wilson was later informed on February 5 that Penn Central's cash picture for the first six months of 1970 "is very tight" (Ex. PX-11 (A-71)), he was not surprised. During the September 11, 1969 meeting Wilson had been told that Penn Central's cash position would be tight for the first quarter. The prediction of "tight cash" extended from the first three months to the first six months did not prompt Wilson to conclude that Penn Central was not creditworthy (Wilson, Tr. 862-63), because he received a reasonable explanation from O'Herron. At trial Wilson testified about O'Herron's explanation:

> THE WITNESS: The accountants had made them take a special charge in the fourth quarter on certain snow removal equipment, I believe.
>
> THE COURT: Write down, you mean, or off?
>
> THE WITNESS: They'd write down or off. An awful lot of this equipment was self-insured by the railroad, and either because of damage or usage or whatnot, I think it was a $6 million charge -- it is in one of these blue sheets here, the amount of it; and secondly, the fourth quarter, particularly in December, the severe snow storms in the northeastern part of the United States had resulted in less profits than they had anticipated.

(Wilson, Tr. 877-78).

News of tight cash and extraordinary write offs were balanced in Wilson's experienced view by Penn Central's

plans to raise cash. Wilson knew, both from the initial and the ongoing credit investigation, that Penn Central had substantial assets to sell, pledge, or hypothecate in order to raise cash to meet its obligations as they came due. The real question was whether management had feasible and prudent plans to convert those assets into cash and it was on this question that Wilson focused.

Access to Credit

From the fall of 1969 to March of 1970, Goldman, Sachs was careful to check that Penn Central had access to credit. (See, e.g., Vogel, Tr. 510-11). This review, built principally upon Vogel's credit analysis, took many forms.

Information obtained during the September 11 discussion included the facts that Penn Central had $240 million in receivables, had investments in securities which could be liquidated and that a substantial financing was being contemplated by the Pennsylvania Company, Penn Central's wholly-owned subsidiary, the proceeds of which would be available to the parent railroad company as needed. (Ex. PX-20 (A-90)).

A short time later, Goldman, Sachs' view that Penn Central had access to credit was confirmed when Patrick F. Bowditch, Vice President in the Transportation division of the First National City Bank, called Jack Vogel. Mr. Bowditch

was "in complete agreement with our position that Penn Central is a unique credit with substantial asset values. He feels that they have the resources to raise substantial funds if it became absolutely necessary." (Ex. A-84). He even expressed a willingness to increase the revolving credit agreement with Penn Central to a higher amount if needed. To Vogel "that was certainly an important indication of the willingness to lend them further. He seemed to agree with me on our analysis of the picture." (Vogel, Tr. 523). And to Wilson, "It was reconfirming our own judgment and I was pleased to see it." (Wilson, Tr. 864).

On November 12, 1969, Pieter A. Fisher, a representative of Goldman, Sachs' Corporate Finance Department, met with O'Herron to discuss Penn Central's financing plans. The memorandum which was prepared describing this meeting provided Goldman, Sachs with additional information for its on-going credit analysis. (Ex. PX-25 (A-80)). The substance of this conversation between Fisher and O'Herron shows that Penn Central enjoyed the backing of major financial institutions, had several available options for raising cash as necessary, and had sensible and prudent plans to effectuate the raising of cash.

"Bank checkings," which were incorporated into the credit file on December 15, took place between June and

December of 1969 and uniformly showed that the banks being questioned was willing to extend credit to Penn Central, regarded Penn Central as creditworthy, and had a high regard for its management. (Ex. A-76). In a sense, there can be no better proof of a company's access to credit than the opinion of the banks which lend money to a company that they deem that company creditworthy.

In the middle of December, 1969, another development occurred which demonstrated that Penn Central had access to credit. On December 16, 1969, the offering circular for the $50 million Pennsylvania Company debenture offering, which had been talked about at the September 11 meeting, was distributed. (Ex. A-12). Pennsylvania Company was the wholly-owned subsidiary of Penn Central and, according to its offering circular, had investments in other companies at an estimated value of more than $900 million. The Pennsylvania Company's circular was made part of the credit file of Goldman, Sachs and served to provide Goldman, Sachs with information about the underlying assets of Penn Central. On December 17, 1969, an article in The Wall Street Journal indicated that this debenture offering had been oversubscribed (Ex. A-184), and within a week, the $50 million Pennsylvania Company debenture offering was sold. This favorable information confirmed Goldman, Sachs' judgment that Penn Central was creditworthy,

not only because Penn Central was able through its wholly-owned subsidiary to raise $50 million, and investors in the financial community were eager to invest in the offerings of the Penn Central system,* but also because it showed that management was capable of completing financial plans that had earlier been described to Goldman, Sachs.

In explaining Penn Central's 1970 projected budget during the February 6 meeting, Bevan described Penn Central's need for cash. (Ex. PX-12 (A-69)). Although the financial needs were great in terms of absolute numbers -- $225 million -- that sum was not viewed by Goldman, Sachs as extravagant for a $6 billion company. Moreover, what impressed both Wilson and Levy was that Penn Central had plans for reaching its financial goals which they believed were feasible and prudent. Levy testified that "I hadn't had time to deal in depth with it, but it looked feasible." (Levy, Tr. 756). And based upon years of experience in investment banking (Levy, Tr. 730, 733-34, 739-43; see Exs. FD and FE), he concluded at that time that "It sounded feasible to me."

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* Although unknown to Goldman, Sachs at the time, the evidence in this case reveals that in December, 1969, other financial institutions were willing to extend additional credit on an unsecured basis to Penn Central. Thus on December 24, 1969, Manufacturers Hanover Trust Company, at that time the fourth largest banking system in the United States, advanced Penn Central $7.5 million in an unsecured loan. (Sullivan, Tr. 842, 860-61).

(Levy, Tr. 756).*

Judgments about Penn Central's creditworthiness reached by Wilson at the time of the February 6 meeting were confirmed by events in the following weeks. Shortly thereafter the meeting Goldman, Sachs learned that Penn Central had been able to obtain with celerity an unsecured $50 million bridge loan to Pennsylvania Company (Ex. PX-23 (A-64); Vogel, Tr. 548). This verified at least two judgments of Goldman, Sachs. First, it was proof that Penn Central continued to enjoy access to credit. There is little doubt that if major banks had thought Penn Central was not creditworthy, they would not have lent money to Pennsylvania Company. (Sullivan, Tr. 873-74). Second, loan confirmed the opinion of Goldman, Sachs that even if lines were difficult to obtain, banks were still willing to lend money to the Penn Central complex. (Levy, Tr. 758; Vogel, Tr. 548).

It was not until long after March 13, 1970, that events occurred that first cast doubt on Penn Central's creditworthiness. Although in early February, Penn Central

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* On the basis of much the same information that was available to Goldman, Sachs, John J. Sullivan of MHT concluded after reviewing a report of the February 5, 1970 meeting between Penn Central and its banks (including MHT) (Exs. AA & AD), that, "he expected that the Pennsylvania Company would be able to sell its [debentures] and that the bridge loan . . . would be repaid from the proceeds of that successful sale." (Sullivan, FSB Tr. 868-69); see also id. 871).

had several plans and different options open to it by which it could raise necessary capital, the officials of the Railroad during the months of April and May narrowed their options to one. In effect, by placing all their hopes on a $100 million debenture offering in Pennsylvania Company, they put all their eggs in one basket. This was the spring of Cambodia, Kent State, and an unstable stock market. During these times, many issuers were unable to obtain funds through public offerings. (Ex. FJ). Penn Central was one of these.

When its $100 million debenture offering had to be withdrawn, Penn Central turned immediately to its sole contingency plan. It went to the government and asked for a $200 million loan which would enable it to continue operations. When the unexpected happened and the government refused to extend credit, Penn Central -- the largest transportation company in the world and the sixth largest corporation in the United States -- was left without any options and no time to think of new ones. Although in early 1970 months separated events of significance, in April and May weeks separated financial happenings, and in June it was merely a matter of days. With no time to devise new strategies for financings, the officers of Penn Central filed for reorganization.

But even the events of June 21, 1970, did not reveal a Penn Central empty of assets. Within the system were substantial unencumbered assets that could still have been pledged, sold or hypothecated to raise cash. What was lacking, however, was a management that had alternative realistic plans to raise cash upon those assets. (Levy, Tr. 760-62; Wilson, Tr. 935-37).

B. No Fact Presented By Plaintiff Impugns The Integrity Of Goldman, Sachs' Credit Investigation Or Its Reasonable Basis For Concluding That Penn Central was Creditworthy

The preceding discussion has largely focused upon Goldman, Sachs initial and ongoing credit investigation and has shown that when unfavorable news about the issuer came to Goldman, Sachs' attention that it was carefully weighed and analyzed. By reconstructing the investigative and analytic processes of Goldman, Sachs, we have shown as well the reasonable basis for Goldman, Sachs' judgment that Penn Central was creditworthy. Plaintiff also attacks both Goldman, Sachs' conclusions and its methods under the rubric of Rule 10b-5 misrepresentation by claiming that Goldman, Sachs misrepresented first that Penn Central was creditworthy and second that it had conducted an adequate credit investigation. Instead of offering a coherent explanation of its theory of misrepresentation, however, plaintiff has offered

a catalogue of separate and unrelated arguments, none of which withstands analysis.

1. Goldman, Sachs did not misrepresent that Penn Central was creditworthy

In advancing the argument that Goldman, Sachs misrepresented that Penn Central was creditworthy, plaintiff misstates the issue. Goldman, Sachs never represented to anyone that Penn Central was creditworthy; it did, however, represent that it had a reasonable basis for its judgment that Penn Central was creditworthy. The securities laws do not mandate that one predict correctly but simply require that there be a reasonable basis for any prediction. Liability is not imposed on one who after reasonable investigation and in good faith reaches a conclusion that in hindsight turns out to be wrong. Accordingly, the question is not whether Goldman, Sachs misrepresented that Penn Central was creditworthy but rather whether Goldman, Sachs misrepresented that it had a reasonable basis for its judgment that Penn Central was creditworthy. (See Defendant's Trial Memorandum, at 70-76). A reading of plaintiff's brief, however, reveals that the trial record is wholly inadequate to establish that Goldman, Sachs did not have a reasonable basis for its views.

UHF urges several separate arguments as support for its assertion that Goldman, Sachs misrepresented that

Penn Central was creditworthy, which can be roughly characterized as: (i) the hybrid presumption, (ii) the alleged inability of Penn Central to obtain bank lines, (iii) "a cursory review" of Penn Central's financial status, and (iv) the inventory guideline decision and the February 9 repurchase.

Hybrid Presumption. Even assuming for the moment that plaintiff's hybrid presumption has any relevance on the instant facts,* it is patently untrue that, as plaintiff writes, "[d]uring the period between March 13, 1970 and the time when PENN CENTRAL filed its petition, there were no significant changes in the condition of PENN CENTRAL." (Plaintiff's Post-Trial Brief, at 64). Not only did the condition of Penn Central deteriorate but so did that of the entire economy. The spring of 1970 was the spring of Cambodia and

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* All the cases relied upon by plaintiff arose in the context of disputes between two parties in which one party was held to be bound by or to have known of a material fact which was peculiarly within his knowledge or control at some time prior to the discovery or announcement of that material fact. None of the cases dealt with the situation in which a third party is presumed to have knowledge of or be bound by the existence of a fact at an earlier date when that fact was peculiarly within the knowledge of another party. That is, plaintiff's hybrid presumption cases would apply, if at all, only if plaintiff had sued Penn Central, in which case plaintiff would then assert that Penn Central knew of its own insolvency prior to June 21, 1970.

Kent State; it was the spring in which Penn Central unsuccessfully attempted to raise $100 million in a debenture offering;* and it was the spring in which on April 22, 1970 Penn Central had suffered a consolidated loss of $17 million for the first quarter of that year and an unconsolidated loss larger than that for the entire previous year. (Wilson, Tr. 935-37; Ex. PX-46). Although each of these facts might rightly be deemed significant enough to forestall the application of any hybrid presumption, certainly the synergism of these discrete developments worked a material change in the position of Penn Central, totally unforeseeable at the time of plaintiff's purchase.

This conclusion finds support in the opinion of Judge Metzner in Franklin Savings Bank. Since plaintiff invokes so readily the opinion of Judge Metzner on other points, it is strange that it has missed the point made by Judge Metzner that he could not justify "making the assumption that simply because reorganization occurred in the middle of June, this commercial paper was not properly sold

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* Q. What was the state of the market in the spring [of 1970]?

A. [Sullivan] It was a very disturbed market as I recall. Interest rates were rising, money was very tight."

(Sullivan, FSB Tr. 869).

as prime by Goldman, Sachs in March." CCH Fed. Sec. L. Rep. ¶ 95,389, at 98,968. Moreover, the reason a hybrid presumption cannot be applied in the instant case is because of the rapidity of change in the condition of Penn Central from week to week during the period mid-1969 to June 1970. Speaking in the context of the time period from October 1969 to March 1970, Judge Metzner wrote that no reliance could be placed on a report of the Interstate Commerce Commission (Ex. PX-64) granting approval to an increase in the outstanding amount of commercial paper because "this approval was issued in October 1969, too remote in time to be relied on in this case. We are talking about six months later in what appears to have been fast-moving events in Penn Central's financial picture." Id. at 98,969. This reasoning applies with greater force to the three months after plaintiff's purchase but before the filing of Penn Central's petition.

Bank Lines. Plaintiff next asserts that Penn Central could not have been creditworthy because it was unable to obtain 100% bank line coverage. Two errors, one logical and both practical, are inherent in plaintiff's arguments: (i) there is no record evidence that Penn Central was unable to obtain bank lines, and (ii) failure to obtain bank lines is not necessarily and cannot be presumed to be credit related.

Contrary to plaintiff's assertions, the record facts at most show that Goldman, Sachs held the view that Penn Central was unwilling to obtain bank lines because it did not want to pay costs of those lines and preferred to impose those costs upon Goldman, Sachs by permitting Goldman, Sachs to maintain an inventory of unsold Penn Central commercial paper.

In an attempt to establish that Penn Central was unable rather than merely unwilling to obtain bank lines, plaintiff quotes the deposition testimony of Raymond Lepley. Lepley, however, said no more than that "arranging more lines would be difficult and expensive." Testimony at trial establishes that such difficulties and expenses were not credit related, but rather reflected the general economic climate at the time. (Doty, Tr. 686). Moreover, according to Lepley's further testimony, he was not authorized or sufficiently knowledgeable to judge the financial situation of Penn Central at this time. First, in the testimony quoted by plaintiff Lepley states that he is only able to describe a "general feeling" among the people at Penn Central. Second, the reason for Lepley's describing only a "general feeling" is found in a portion of Lepley's deposition not quoted by plaintiff, where Lepley explains:

> "In December, I had no idea on the financial condition of the company. On

> January 6, when I wrote this [a memorandum not in evidence], I was probably parodying what somebody had told me would be a poor earnings report for the '69 fourth quarter."

(Lepley Dep. 54). When Lepley's testimony about the difficulty of obtaining bank lines is read together with his testimony that at that time he had "no idea on the financial condition of the company" and in expressing opinions he was "parodying" what he heard from others, it is clear that his views are not to be taken as substantial evidence of the actual condition of Penn Central.

Even assuming arguendo that Penn Central was in fact unable to obtain additional bank line coverage, plaintiff has not established that any such hypothetical inability was related. In support of its proposition plaintiff merely cites the statement of Jack Vogel that "[i]f [a company] is not creditworthy, they won't get bank lines . . . ." (Vogel, Tr. 594).

Plaintiff then impermissibly twists Vogel's words to assert the conclusion that a company that cannot get bank lines is not creditworthy. Contained in plaintiff's argument is a logical flaw, known to schoolboys since the days of Aristotle as "the affirmation of the consequent." The obvious fact that non-creditworthy companies cannot get bank lines, does not logically prove, tend to show, or give rise to an inference that a company

which cannot get bank lines is necessarily uncreditworthy.*

In context, moreover, it is apparent that Vogel was merely explaining that if a bank concludes a company is not creditworthy then that bank will not grant a line of credit; and was not saying that every failure or refusal of the bank to extend a line to a company necessarily reflects the judgment of that bank that the company is not creditworthy. A bank may decline to extend credit for a variety of reasons not bearing on the financial condition of the issuer. For example, in a period of tight money, such as existed in late 1969 and early 1970, a bank may well have already extended as many lines as it reasonably thought it could cover if called upon to do so. (Vogel, Tr. 515-16).**

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* "Let us assume it to be true that if Jones has a headache he takes aspirin. It would be fallacious to argue that since he took aspirin, he had a headache. It would be equally fallacious to argue that since he didn't have a headache, he wouldn't take aspirin. Aristotle classified both these fallacies under the heading of fallacy of the consequent. [E]ssentially . . . both consist in supposing that because we can argue from a condition to a consequent, we may argue from the consequent to the condition." R. Clark & P. Welsh, Introduction to Logic 145 (1962).

** Or, as George Doty explained:

> Q. Do you know whether during a tight money period there is any difference between the willingness of banks to extend lines or to grant loans?
>
> A. Well, they always prefer to -- "always" is a big word, but the preference in banks, particularly in time, in crunch times, in tight money times, is

(Footnote continued on next page)

Furthermore, Vogel certainly did not say that when a company chose not to seek lines and accordingly there had never been a refusal to extend lines, that any credit inference was to be drawn from this fact.

At trial, moreover, the Court expressed a more natural understanding of Vogel's words.

"THE COURT: . . . The availability of bank lines is a good device for marketing commercial paper to investors, but it doesn't have any material effect on the credit of the issuer, creditworthiness of the issuer?

(Footnote cont'd.)

to lend. A line is just a call on them, which can be used to the borrower's advantage, and we notice in all of these crunch periods that the banks tend to chase their borrowers with or without lines into our market, so that the economics of it work against a bank.

If he lends you, he knows what he's earning, he knows what his problem is, and he commits the funds, and he gets the return that he desires to have.

In the line business, he is not getting the full leverage on his money. It's always our practice -- it's always been -- that it's cheaper and more effective for us; we have never had any trouble borrowing the money, and when you go in with a specific piece of business at a particular moment, they'll lend it to you, if they think the credit is acceptable credit.

(Doty, Tr. 686-87).

THE WITNESS: That's correct, sir."

(Vogel, Tr. 515).

Plaintiff, then, has not met its burden of proving that it was more likely than not that Penn Central was unable to obtain bank lines. Rather, the evidence shows that Penn Central desired to avoid paying the costs of obtaining bank lines and that this was the basis for its reluctance to approach banks on the subject.

Cursory Review. Plaintiff does not dispute Jack Vogel's methodology nor the results reached by applying that methodology to the financial facts of Penn Central. Instead of challenging Vogel's expert credentials or taking issue either with his cushion study approach or the conclusion that Penn Central had a cushion of $617 million* -- more than three times the amount of its outstanding commerpaper -- plaintiff cites the deposition testimony of two subordinates of Vogel as support for its proposition that "even a cursory review" reveals a list of financial problems that plaintiff apparently believes are a priori evidence that Penn Central was not creditworthy. Identification of those or other financial problems, however, is the beginning not the end of analysis, and their mere existence does not establish Penn Central's noncreditworthiness. Rather they must

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* See Appendix A.

be considered in the context of Penn Central's substantial assets as was done by Vogel in a form not seriously challenged by plaintiff. Further confirmation that the financial problems on plaintiff's list did not make Penn Central noncreditworthy lies in that they were all publicly known, and indeed most were widely reported in the press. Nevertheless, almost every major lending institution in the country was willing to put its money behind Penn Central. Why? The answer is found, as demonstrated in Appendix A, in the substantial assets of the largest transportation company in the world.*

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* It should be noted for the record that plaintiff's citation of the deposition testimony of Robert Hoffman has been objected to by defendant on the ground that it concerns events and work done by him after March 13, 1970. Hoffman performed his credit analysis of Penn Central based upon year-end 1969 financial information which he obtained from Penn Central's 1969 annual report, dated March 16, 1976. Because the issue in the case is not whether Penn Central was in fact creditworthy but whether Goldman, Sachs had a reasonable basis for its judgment that Penn Central was creditworthy, this information does not relate back to December 31, 1969, and accordingly is irrelevant.

Second, it is not true that Vogel could not recall that there were two credit analysts during the relevant period working on the Penn Central account. Vogel simply could not, more than five years after the critical events -- and without opposing counsel having placed before him the documents which would have and later did refresh his recollection -- recall their names. Nor is it accurate to say there were only two credit analysts assigned to Penn Central: Vogel himself, Goldman, Sachs' chief credit analyst, did much of the work himself since he viewed it as an "unique" credit.

Repurchase and Inventory Guideline. Finally, plaintiff argues that the $10 million repurchase on February 9, 1970 and the $5 million inventory limitation on Penn Central commercial paper indicated at the very least that Goldman, Sachs had no confidence in its credit evaluation of Penn Central. The facts are otherwise. The reduction in inventory on February 9 and the $5 million ceiling -- which was subsequently many times exceeded -- were made for sound business reasons totally unrelated to the creditworthiness of Penn Central.

These arguments have already been set forth in detail in Point I above, and at this stage it is necessary only to state that plaintiff seeks to draw an inference from Wilson's March 23, 1970 blue sheet (Ex. PX-14) (admitted into evidence only to the extent it related back to events that occurred prior to March 13, 1970) without considering the essential testimony of its author.

> "Q. I call your attention particularly to the statement about the middle of that memorandum. . . .
>
> 'G.S. & Co. felt that a $5 million ceiling was appropriate until such time as they obtained 100 percent line coverage, completed some of these long-term financings and started to reduce the operating losses.'
>
> * * *
>
> Do you recall making that statement to Mr. O'Herron?

A. [Wilson] Yes.

Q. Why did you make that statement to Mr. O'Herron?

A. I think I was irritated at him.

Q. Will you explain that a little further?

A. I had been asking him for some months in here to get some more bank lines, to obtain some more swing lines, and here it is five or six weeks after we had had lunch on February 6 and I haven't gotten any results yet, and now he presents me, I think I had come back from vacation here and he presents me saying that the first quarter figures are going to look terrible, and to my mind, there was going to be certain investors that were going to temporarily stop buying some of this paper, and there was going to be a run-off of 50 million or 100 million or some number like that, and he wasn't doing what he was hiring us as experts in this field and he wasn't following my advice, and so I said, 'All right' --

THE COURT: 'I mean it.'

THE WITNESS: 'I mean it, and I'm now going to up the ante on you. I'm going to say you have got to get this financing done which you have been talking to me about since February. You haven't filed it yet. And one way I'm going to force you into your own bank lines is to put some kind of a target or a ceiling in here of a relatively small amount, $5 million,' and so it was the next phase of the negotiation he and I had had going on for sometime."

(Wilson, Tr. 909-10). Goldman, Sachs' action in insisting on the $5 million inventory ceiling, then, did not reflect

a loss of confidence in the creditworthiness of Penn Central. The more reasonable inference is that Robert Wilson, in dealing at arms length with Jonathan O'Herron, had during the course of many months been on the losing end of ongoing negotiations over who should bear the cost of maintaining unsold Penn Central commercial paper. Nothing in the record even intimates that these negotiations were not conducted within the bounds of ethics and were anything other than the ordinary conduct of businessmen arguing over a most essential concern -- money. Plaintiff seeks to warp this relationship and these dealings into something sinister: plaintiff argues that Goldman, Sachs should have inferred from the fact of hard bargaining the conclusion that its business adversary was not worthy of belief and could not be trusted. Neither law, nor logic, nor common sense imposes or tolerates such a presumption.

2. Goldman, Sachs performed an adequate credit investigation.

In lieu of any substantial challenge to Goldman, Sachs' position that it had a reasonable basis for its view that Penn Central was creditworthy, UHF concentrates its energy on its argument that Goldman, Sachs misrepresented that it performed an adequate credit investigation. Plaintiff's arguments in this regard are separately considered immediately hereafter.

a. A Commercial Paper Dealer is not Subject to the Standards of an Underwriter

Plaintiff initiates its attack on Goldman, Sachs' procedures and methodology by reference to and reliance upon Sanders v. John Nuveen & Co., 524 F.2d 1024 (7th Cir. 1975), petition for cert. filed, No. 75-1065. Such reliance is misplaced, but because Nuveen also involved commercial paper, examination of its particular facts may be justified.

Nuveen was the commercial paper dealer for the notes of Winter & Hirsch, Inc. ("WH"), a finance company. When WH went into bankruptcy, 42 investors held its commercial paper in the total aggregate amount of $1.6 million. In marked contrast to the Penn Central commercial paper investors, most of the holders of WH paper were individuals and 40 of the 42 held notes in denominations of from $3,000 to $100,000. Probably for this reason the Nuveen court in

a previous opinion, 463 F.2d 1075 (7th Cir.), cert. denied, 402 U.S. 1009 (1972), had concluded that the WH commercial paper was offered to the general public and did not qualify for exemption under Section 3(a)(3) of the Securities Act of 1933. Because the Court interpreted the exclusion from the definition of "security" under Section 3(a)(10) of the Securities Exchange Act of 1934 ("any note . . . which has a maturity at the time of issuance of not exceeding nine months,") to refer only to those securities which would qualify for exemption from registration under Section 3(a)(3) of the Securities Act of 1933,* the Court held

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* Defendant disputes the logic embodied in that Court's opinion, believing that the statutory definition is unambiguous and that the commercial paper at issue there, as here, was a note with a maturity at the time of issuance of less than nine months, and accordingly was not a "security" under the 1934 Act. Recognizing, however, that this Circuit has accepted the proposition that the 1934 Act excludes only those notes which are "of the type" which qualify for exemption under Section 3(a)(3), Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973), defendant merely notes its position in this Court. In any event, although defendant believes that the Penn Central commercial paper would meet the tests enumerated in Nuveen and Zeller (see Franklin Savings Bank, Plaintiff's Post-Trial Brief App. B, at 8-13), and that the test of "prime quality", measured prospectively, was met in the case of Penn Central, it is not necessary for the Court to reach that issue. Unlike the intrastate sale involved in Franklin, the UHF purchase was an interstate transaction and admittedly subject to Section 12(2) of the Securities Act. Because the subject matter jurisdiction of the Court is not challenged it becomes relatively academic whether the issues are also to be judged under Rule 10b-5 or solely under Section 12(2) of the 1933 Act.

that the sale of WH commercial paper was subject to SEC Rule 10b-5 under the 1934 Act.

In the more recent opinion, Circuit Judge (now Mr. Justice) Stevens affirmed the District Court's finding that Nuveen had violated Rule 10b-5 in its sales of WH commercial paper. Notably, the Court also affirmed the District Court's conclusion that Nuveen's sales did not violate Section 12(2) of the Securities Act because no prospectus was involved in the sale of the notes. The Court of Appeals concluded, however, that Nuveen was liable as an "underwriter" because it failed to detect the fraud being perpetrated by WH and its accountants -- a fraud which had resulted in the publication of false financial statements for many years.

On its facts the Nuveen case is readily distinguishable from Penn Central. There is no evidence whatsoever in this trial record, unlike that before the Court in Nuveen, that Penn Central or its auditors were fraudulently delivering to Goldman, Sachs false and misleading financial information, or that any attempt by Goldman, Sachs to verify the accuracy of the financial information rendered to it by Penn Central or Peat, Marwick, Mitchell & Co. would have uncovered different information.

What was central to the Nuveen decision was the Court's concern that there be "at least some investigation

directed at the question whether the ever present possibility of fraud is in fact a reality." 524 F.2d at 1071. Unlike Nuveen, there is no evidence that such an investigation would have uncovered any fraud in this case.

In any event the degree of investigation required depends upon all the surrounding circumstances involved, and the obligation to investigate has never been thought to give rise to immutable rules as to what must be done in all cases.* Nothing in Nuveen does away with the traditional flexibility of the securities laws in defining such duties, and accordingly, Nuveen cannot be applied directly to Penn Central without far more closely analogous facts than here exist.

More fundamental, however, is what should be recognized as a basic error in the Seventh Circuit's reasoning, namely the assumption without analysis that a commercial paper dealer is an "underwriter" subject to the obligations which courts have imposed upon underwriters in actions brought under Section 11 of the Securities Act.

Definitions of course impose no duties or obligations, but merely permit the drafters of legislation to use

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* E.g., Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969) ("[T]he degree of independent investigation which must be made by a securities dealer will vary in each case. Securities issued by smaller companies of recent origin obviously require more thorough investigation.") Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 289 & n.6 (E.D. La. 1974); Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 382-83 (1963).

words with defined meanings in statutory provisions which impose rights and obligations. Even if one were to assume that Goldman, Sachs fit the statutory definition of underwriter,* the obligations deriving from such status would only be those imposed by particular sections of that act.

The statutory scheme imposing civil liability under the 1933 Act reflects certain carefully circumscribed obligations including those imposed upon underwriters as defined in the statute. As the Supreme Court has recognized, the 1933 Act is concerned primarily with the initial offering of securities to the public, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 (1975), and provides civil liabilities in three separate provisions:

-- Whether securities are exempt from registration or were registered, the seller may be liable under Section 12(2), but there is in that section no reference whatsoever to an "underwriter" and thus no duties are imposed even if a dealer fits within the

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* In pertinent part, Section 2(11) of the Securities Act defines an "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . . ."

definition of underwriter contained in the statute;

-- If securities are not exempt from registration and were not registered, the seller is absolutely liable under Section 12(1);*

-- If securities are required to be registered and are registered, the obligations of those participating in the offering, including an underwriter, and specific defenses available to them, are set forth in Section 11.**

In the context of Nuveen, then, the status of underwriter has significance in terms of civil liability only under Section 11 of the Securities Act for material misstatements or omissions made during a distribution of securities registered under Section 5 of that Act.*** But because no registration statement was filed by WH, civil liabilities could not

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* Penn Central was in any event exempt from Section 5 by virtue of its exemption as a transportation company under Section 3(a)(6).

** Theoretically they would also be subject to suit under Section 12(2), but the burden on a plaintiff is less under Section 11.

*** In other contexts, whether securities are sold by an underwriter has significance in terms of whether the securities must be registered under Section 5 (see Section 4(1): "transactions by any person other than an . . . underwriter . . .").

be predicated under Section 11 and accordingly, no Section 11 duties should properly have been imposed upon Nuveen. Recognizing that Section 11 was inapplicable, the Nuveen court chose to import into Rule 10b-5 under the 1934 Act, the obligations of an underwriter under Section 11 of the 1933 Act, but stripped of the defenses which protect an underwriter from liability under the latter provision.

The potential liability of an "underwriter" in Section 11 is subject to specific affirmative defenses available to an underwriter. Cognizant of those provisions, investment bankers participating in a registered offering normally conduct such investigation as would permit them to invoke the affirmative defenses available under Section 11 should a misstatement or omission be contained in the prospectus in spite of their "due diligence." For example, an underwriter is absolved of liability for inaccuracies in expert statements such as certified financials if "he had no reasonable ground to believe and did not believe" them to be inaccurate. Securities Act of 1933, Section 11(b)(3)(C). In importing the definition of underwriter into Rule 10b-5, however, that defense was virtually abolished by the Nuveen Court. See 524 F.2d at 1069-71.

Moreover,the cases quoted by the Nuveen court, and in particular Judge McLean's opinion in Escott v. BarChris

Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), are inapposite except in situations involving registration statements which contemplate a sale of securities at a particular moment, where an investigation is conducted to determine financial status of the issuer as of a particular date, as contrasted with the ongoing sales of commercial paper over a period of months or years.

The failure of the Nuveen Court to differentiate between the carefully circumscribed obligations imposed under Section 11 and the fraud provisions of Rule 10b-5 may be understood by recognizing that the Seventh Circuit requires no finding of scienter under Rule 10b-5, a holding presently under review by the Supreme Court. Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), cert. granted, 421 U.S. 909 (1975). So long as this Circuit requires scienter for a finding of violation of Rule 10b-5, or unless the Supreme Court should approve the Seventh Circuit's rule, the liabilities of a dealer should be judged by the decisional law imposing upon a dealer merely an obligation to have a reasonable basis for its recommendation, and not by the standard imposed upon an underwriter in a registered offering under a statutory provision clearly inapplicable to this defendant.

b. Assets of Penn Central Transportation Company

Lacking not only the testimony but apparently also the advice of a credit expert, plaintiff next pursues

an argument which shows nothing but its own inability to comprehend simple balance sheet accounting principles. Plaintiff asserts that Goldman, Sachs in its credit investigation overstated the value of Penn Central assets by $1-1/2 billion. Plaintiff somehow forgets the patient explanation of Vogel during his cross-examination:

> Q. Would you have been surprised to learn, if you had read this document [Ex. PX-67] on October 1, 1969, that in Mr. O'Herron's opinion Penn Central's assets totaled 4.5 billion, on the third line of Page 3?
>
> A. No. He was referring to the transportation company alone figure. I was referring to the total complex.
>
> Q. But wasn't Mr. O'Herron's figure a more accurate figure in terms of what was available as assets for commercial paper?
>
> A. Just for the railroad in terms of its application. It had nothing to do in terms of what was available.
>
> Q. The railroad was issuing the paper; isn't that right?
>
> A. Yes. The railroad also had additional investments in the subsidiaries that raised the total to 6 billion.

(Vogel, Tr. 664-65). Moreover, plaintiff seemingly ignores the Court's rejection of this notion that only the assets directly owned by Penn Central Transportation Company were relevant.

> MR. ATLAS: Objection. I don't see what the relevance is. We are talking about Penn Central Transportation.

THE COURT: No, I can't agree with this theory of yours that it is per se an impossibility for the companies to lend each other money back and forth, or to back each other's situation. We are talking about a 100 percent-owned company.

(Vogel, Tr. 669).

In order to resolve plaintiff's confusion the corporate structure of Penn Central must be briefly explained. (See Defendant's Trial Memorandum, at 25). Public shareholders owned the stock of Penn Central Company, a holding company the principal asset of which was Penn Central Transportation Company.* The assets of Penn Central Transportation, the issuer of commercial paper, can be roughly broken down into three components: (1) railroad operations, (2) Pennsylvania Company ("Pennco"), and (3) other operating subsidiaries. Plaintiff's confusion appears to be caused by its belief that Goldman, Sachs was looking to the holding company to pass assets or cash downstream to the Penn Central Transportion Company in time of need. Rather, Goldman, Sachs was looking to particular wholly-owned or majority-owned subsidiaries of Penn Central Transportation

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* Penn Central also owned certain other assets outside of Penn Central Transportation Company. These were Southwestern Oil & Refinery Co., Royal Petroleum Corp., and Penn Central International. At no time did Vogel consider these as usable assets in conducting its credit investigation. (Vogel, Tr. 588-89).

Company and considered that it was reasonable to believe that they could and would pass money upstream if requested or required to do so by their parent -- Penn Central Transportation Company.

If one looked at railroad operations only, as O'Herron had to do for purposes of Penn Central's I.C.C. application, the figure of $4.5 billion in assets would be correct. But if one looked to the consolidated balance sheet of the issuer of commercial paper -- Penn Central Transportation Company -- the figure of $6.0 billion in assets is correct. As Vogel explained, "The railroad [Penn Central Transportation Company] also had additional investments in the subsidiaries that raised the total to 6 billion." (Vogel, Tr. 665).

The only reason Vogel made use of the financial statement of the holding company, Penn Central Company, was that there were no certified financials for Penn Central Transportation Company. Therefore, Vogel used the certified financials of Penn Central Company, subtracted the value of assets other than Penn Central Transportation Company,* and derived a pro forma certified balance sheet for the issuer of commercial paper.

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* In relation to PCTC and its subsidiaries, these assets were insignificant. (See Ex. A-198).

If plaintiff has not merely misunderstood this approach, but actually disputes the propriety of using consolidated figures as opposed to railroad only figures, plaintiff has not met its burden of proof on this issue. It offered no testimony, expert or otherwise, that it was unreasonable to use consolidated figures. To the contrary, the evidence shows that on several occasions millions of dollars were passed upstream from Pennco and that the very idea of the $100 million Pennco debenture offering in the Spring of 1970 was also to pass the proceeds upstream to the Penn Central Transportation Company. Thus in assessing access to credit, it is both logical and historically accurate to assume that the cash generating powers of subsidiaries is a valid consideration. Accordingly the relevant asset figure is $6 billion and not $4.5 billion.

c. Structure of credit department.

Plaintiff criticizes the structure of Goldman, Sachs' credit department. It complains that credit reviews were not in writing, that credit analysts had too many issuers to follow, that it was improper to have college students conduct bank checkings, and that credit analysts had no significant contacts with Penn Central. All of these points are baseless. To begin with, plaintiff offered no evidence, by expert testimony or otherwise, that

it was unreasonable for Goldman, Sachs to structure its credit department and to conduct credit analyses in the fashion that it did. Rather, the testimony of the only expert witness on this point -- Jack Vogel -- demonstrates the intrinsic reasonableness of Goldman, Sachs' procedures and structure.

The Court itself recognized that it is not necessarily unreasonable to conduct business by word of mouth.

> "THE COURT: You people on Wall Street do the most amazing things by way of mouth, I take it that was a custom of the trade.
>
> "THE WITNESS: [Van Cleave]: Yes."

(Van Cleave, Tr. 368). Although the above comment was made in the context of Van Cleave's explaining that Goldman, Sachs would ask issuers orally about their use of commercial paper proceeds, it applies equally to the situation of Vogel's credit analysis. People like Vogel who live day in and day out with the financial facts and figures of a company feel no need, and properly so, to put in writing many things that to the non-initiated may seem overwhelming in their complexity.

By insinuating the impropriety of Goldman, Sachs' using college students to conduct bank checkings, plaintiff fails to distinguish between the relevant and irrelevant.

It is not relevant who asks the question; it is relevant who gave the answer and what answer was given. Every bank interviewed by Goldman, Sachs -- including some of the most important and outstanding financial institutions in this nation -- when asked whether they considered Penn Central to be creditworthy, replied in the affirmative. These institutions had identical or better access to Penn Central than did Goldman, Sachs, were well aware of the financial status of Penn Central, and were undoubtedly cognizant that Penn Central was going through a difficult time as part of the process of realizing merger economies. Notwithstanding all the adverse news about Penn Central's financial condition, these financial institutions consistently continued to deem Penn Central creditworthy. Their votes of confidence were not cast in written credit reports, but in hard dollars -- dollars lent to Penn Central.

As for Goldman, Sachs' credit analysts being over-worked, for plaintiff to make this argument it was essential for it to produce some testimony that one analyst's covering 40 to 60 issuers is unreasonable and precludes an analyst from doing an adequate credit investigation. There is no such evidence in the record. Moreover, at least in the case of Penn Central (the only case relevant here) there were always two qualified analysts overseeing the credit status of Penn Central. At

all material times, Jack Vogel supervised and independently verified that Penn Central was creditworthy.

Finally, plaintiff argues that it was unreasonable for Goldman, Sachs not to adopt procedures whereby its credit analysts had access to the management of Penn Central. The evidence is clear, however, that the function of the credit analyst was largely information gathering and organizational. Analysts had access to blue sheets and to those at Goldman, Sachs who consult issuers. Plaintiff has not explained why it is unreasonable for Goldman, Sachs to allocate to more senior people the function of communicating with top officers of valued clients. If the information was obtained, the identity of the interrogator, as long as his competence is unquestioned, is irrelevant.*

d. The Methodology of Vogel

Plaintiff next challenges the competence of Jack Vogel. Once again, plaintiff has offered no evidence, by

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* Such an allocation of functions is common for credit investigations. For example, John E. Corrigan, the lending officer of the First National Bank of Chicago responsible for Penn Central in 1969 and 1970, testified that in reaching a judgment of creditworthiness, First Chicago divided responsibilities between employees who were charged with collecting and analyzing routine statistical material and employees who were charged with making the ultimate judgment. Contacts between the bank and the borrowers were made only by those charged with ultimate responsibility. (Corrigan Dep. 7).

expert testimony or otherwise, that would in any way question the ability and integrity of Vogel to conduct a credit investigation. Moreover, the points raised by plaintiff in its brief are easily explained by reference to the record facts.

Plaintiff criticizes Vogel for not inquiring into the existence of liens upon Penn Central's hotels and real estate in New York City. First, plaintiff's record citations do not support its assertion.* In Exhibit PX-16 (A-61), the April 14, 1970 blue sheet written by Vogel (which was admitted only to the extent that it relates back to events prior to March 13, 1970), the sole reference to liens and New York real estate is:

> In answer to RGW's question, Bevan said that their New York City hotels and properties, although extremely valuable, have several layers of mortgages to contend with. Furthermore, they would not entertain any thought of selling these assets until the final price for the New Haven Railroad has been established.

That paragraph establishes only that Wilson asked Bevan a question regarding Penn Central's New York real estate and from that fact no inference can properly be drawn that Vogel never earlier questioned the existence of liens on New York City real estate.

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* Plaintiff cites the reader to page 490 of the trial transcript. Yet, there no reference appears to liens or to New York City real estate.

Secondly and more fundamentally, whether Vogel knew of the existence of liens on New York City real estate is irrelevant because he testified that he did not rely upon Penn Central's New York City real estate in conducting his cushion study. As Vogel explained in response to a question from the Court:

> "I didn't consider the hotels uptown because they were so mixed up with the New Haven . . . position."

(Vogel, Tr. 496).

Plaintiff's argument that Vogel did not consider the liquidity of Penn Central's assets is not only contradicted in the pages immediately following that cited by plaintiff (Vogel, Tr. 574-77), but also is considered at length in Appendix A to this memorandum.* Suffice it to note at this point first that Vogel considered certain assets of Penn Central in the context of whether they were cash generating (id. 496-97), and second, that by virtue of the fact that commercial paper was generally issued for a period of time not exceeding nine months, Vogel's cushion study considered liquidity. (Id. 574-77).

Although Wilson testified that he first asked Penn Central about the encumbrances of its assets in April 1970, Vogel was aware of those encumbered assets well before that

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* See Appendix A, at A-6 to A-7.

time. Plaintiff's challenge to Vogel's methodology is based upon its unsupported assertion that the $50 Million Pennco Offering Circular (Ex. PX-63 (A-12)) does not reveal the extent or nature of encumbrances on assets. In making this statement, however, plaintiff must have overlooked page 37 of that Offering Circular. There, the circular clearly discloses which stocks owned by Penn Central through Pennco were pledged or escrowed in support of a debt.* Moreover,

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* Moreover, that offering circular enabled Vogel to compare the shares held by Penn Central as of December 10, 1969 with the number of shares encumbered on that date, and to conclude that for at least three subsidiaries encumbrances were minimal.

Company	Shares Owned by Pennco (Ex. PX-63 (A-12), at 7)	Shares Encumbered (Ex. PX-63 (A-12), at 37)	Percentage
Detroit, Toledo & Ironton Railroad Co.	245,329	26,029	10.6%
Philadelphia, Baltimore & Washington R.R. Co.	277,259	38,390	13.8%
Wabash Railroad Company, Preferred	101,836	22,650	22.24%

Although all the 14,000 outstanding shares of Buckeye Pipeline Company were encumbered (Ex. PX-63 (A-12), at 7, 37), the amount of the loan secured was only $35 million and Buckeye's net assets amounted to $132 million as of February and March 1970. Appendix A, at A-17. Not only was the existence of this encumbrance reported in the news media (Ex. A-212), but Vogel was careful to exclude the amount of this debt from the net asset value of the particular assets he analyzed. See Appendix A, at A-21 to A-23.

in his analysis Vogel subtracted from the amount of usable assets all debt of Penn Central and Pennco that was secured by the stock of the subsidiary to the extent the debt was outstanding. Appendix A explains in detail Vogel's thinking and methodology in considering encumbered assets.*

Isolating Vogel's testimony concerning how he responded to the increases in outstanding commercial paper from $100 to $150 million and from $150 to $200 million from the context of his entire testimony, plaintiff next seeks to twist that testimony to indicate that Vogel did nothing at those two times. However, Vogel's ongoing credit investigation consisted of noting each and every material change in the financial condition of Penn Central so that at all relevant times, Vogel knew with sufficient precision what usable assets Penn Central had over and above its outstanding debt. Therefore, when commercial paper outstandings were increased Vogel had simply to deduct the amount of the increase from the figure he had previously arrived at for usable assets. Nothing more was required because Vogel had previously, as part of his ongoing investigation, reached a current figure for Penn Central's usable assets. That Vogel stated he did nothing special or specific when outstandings

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* See Appendix A at A-21 to A-23.

were increased is because being careful and thorough was to Vogel ordinary and common.*

e. Miscellany

Plaintiff reiterates its belief that the nonfulfillment of O'Herron's prediction that the fourth quarter of 1969 would be in the black should have triggered in the minds of the people at Goldman, Sachs a conclusion that O'Herron was dishonest and not to be trusted. As Vogel explained on recross, the failure of one prediction for one quarter to come true did not cause him to lose confidence in O'Herron "[b]ecause it is not unusual, when people talk in terms of earnings, you are talking ahead of time. It's extremely difficult to predict with any degree of accuracy." (Vogel, Tr. 674). Moreover, the reasons why the predictions were not fulfilled was fully explained to Goldman, Sachs, and the unpredictable and nonrecurring nature of the problems identified obviously satisfied Vogel and Wilson that the disappointing results were not reason to distrust Penn Central. (See Ex. PX-12; see also Wilson, Tr. 877-78). At the same time,

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* Plaintiff's quotation from Exhibit PX-20 (A-90) at this point in its brief is baffling. If plaintiff is attempting to say that O'Herron's request to "put out as much paper as possible in April" is tantamount to an increase in commercial paper outstanding, plaintiff simply does not understand the mechanics of I.C.C. authorization. Extending the maturity date of commercial paper in no way affects the amount of paper outstanding.

Vogel recognized that if someone consistently failed to predict accurately, he would alter his opinion about that person. (Vogel, Tr. 674).

Plaintiff also questions the adequacy of Goldman, Sachs' credit investigation by stating that it failed to inquire into the statements of one Hugh Cox, the removal of Penn Central from the approved list of Continental Insurance Company, and the temporary removal from the approved list of Brown Brothers Harriman & Co. The Brown Brothers issue is considered at length in Section IV below, and at this time the memorandum will address only the irrelevance of the Hugh Cox and Continental Insurance nonissues. Wilson's testimony was clear that he did not inquire of Continental Insurance why it removed Penn Central from its approved list because of his past experience dealing with this "particularly awkward account" the actions of which had no "rationale or pattern." (Wilson, Tr. 932-33, 951-52). Wilson's testimony taken in conjunction with Vogel's that commercial paper investors regularly remove and add names to their approved list (Vogel, Tr. 545-46) negative any argument that the removal of Penn Central from Continental Insurance's approved list, for no apparent reason, had any credit significance or materiality whatsoever.

As for the comments made by Mr. Cox which were reported in the newspaper and commented on by Wilson in his blue sheet of November 10, 1969 (Ex. PX-28 (A-83)), Wilson's testimony is explicit:

> "The reason I brought this to the Penn Central's attention, I believe, as part of this negotiation and trying to get John O'Herron to get more lines of credit to back up paper and start absorbing some of our costs that were eating into the spread, because we had been carrying so much inventory.
>
> "This was one more argument I was using to say John, if you will do this and get some more lines, I think it is going to help in the sale of your paper during this very tight money market period and therefore this means Goldman, Sachs won't have to carry so much of your paper."

(Wilson, Tr. 953-54). The reason Wilson could use the statements by Cox as a bargaining tool and still not conclude they had credit significance lies in the context in which Cox made the statement. Cox was a lawyer with Covington & Burling, a Washington, D.C. law firm which had been retained by Penn Central to state its views before the I.C.C. on the proposed merger between the Baltimore & Ohio Railroad and Chesapeake & Ohio Railroad. The views espoused by Cox, naturally enough, were in opposition to that merger since it would produce a larger railroad that could more effectively compete with Penn Central. It belabors reason to conclude -- as apparently does plaintiff -- that every time a company's lawyer moans before a federal regulatory agency that some proposed action

will be to the detriment of his client that this moaning has credit significance. Indeed, common sense dictates that predictions of dire consequences made in that context have little, if any, significance.

Plaintiff asserts that it was improper for Goldman, Sachs to rely on the I.C.C.'s authorization of the increase in Penn Central's outstandings from $150 to $200 million and on the uniform conclusion of almost every major banking institution in the United States that Penn Central was creditworthy. This argument fails to take account of the I.C.C.'s statutory mandate to pass upon the investment risk of securities the issuance of which it authorizes. See Defendant's Trial Memorandum, at 31-32. Moreover, plaintiff misapprehends the role that the extension of credit by other financial institutions played in Goldman, Sachs' credit investigation. These other opinions of creditworthiness did not simply confirm Goldman, Sachs' view. Because a critical question in the determination of creditworthiness is an issuer's access to cash, that other banks did lend or expressed a willingness to lend (e.g., Ex. A-84) was positive proof of access to credit. (Sullivan, FSB Tr. 864-74).

The final challenges to Goldman, Sachs' credit investigation regard the events of February 5 and 6, 1970

and the "issue" of Penn Central's use of its commercial paper proceeds; both of these matters are dealt with in the following section and the arg ments there showing that each is not material so that discl sure was not required apply equally to the analysis that each is not relevant to a credit investigation.

IV. EVEN IF THE COURT WERE TO CONCLUDE THAT GOLDMAN, SACHS WAS UNDER AN OBLIGATION TO CONVEY SPECIFIC ITEMS OF MATERIAL INFORMATION FORMING A PART OF ITS OVERALL ANALYSIS, GOLDMAN, SACHS HERE DID NOT OMIT TO COMMUNICATE ANY MATERIAL FACTS NOT KNOWN TO PLAINTIFF

Goldman, Sachs submits that the analysis presented in Points I, II and III is sufficient for finding in favor of defendant as to each claim against it. Out of caution, however, Goldman, Sachs will demonstrate that even taken separately -- and apart from the fact that they were mere building blocks in its overall credit analysis -- the facts allegedly withheld by it were either immaterial or known to plaintiff. Accordingly, each of the six "omissions" set out by plaintiff in Part IIB of its Post-Trial Brief is separately considered below.*

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* Plaintiff's arguments under state law, which consist almost entirely of quotations from New York and California statutes, have already been the subject of discussion in our Trial Memorandum. It is clear from the trial record that the offer and sale of the commercial paper here at issue occurred in an interstate transaction and not wholly within California, as required by Calif. Corp. Code § 25401, and that the individual commercial paper salesman was not aware of any information not stated to plaintiff, as required under Calif. Corp. Code § 25402. See Defendant's Trial Memorandum, at 107-10. Hence the California law is inapplicable on the facts of this case. Any claim under New York law requires no consideration from this Court, as plaintiff could not recover under New York law if it lost the federal claims and could not recover more under New York law than that to which it would be entitled if it prevailed under the Federal claims.

(Footnote continued on next page)

Note with Respect to the Hypothetical Testimony of Noel LeMay

With respect to each of the "omissions" considered hereafter, plaintiff argues in part that the materiality of the matter not communicated to plaintiff is demonstrated by LeMay's self-serving statements. In each instance LeMay testified that, had he known the information in question, he would not have informed UHF of the availability of Penn Central commercial paper. (E.g., LeMay, Tr. 31) (Brown Brothers Harriman). Goldman, Sachs objected to the admission of this hypothetical opinion testimony by Mr. LeMay (e.g., LeMay, Tr. 27) and the Court allowed a continuing objection to the line of inquiry. (LeMay, Tr. 33).

(Footnote cont'd)

Plaintiff's contention that a different sum is recoverable under state law is predicated solely on the difference between the California state legal rate of interest and the New York legal rate. But the substantive cause of action even under California law merely prescribes as the measure of damages the same as that provided under New York law and under Federal law and, as under Federal law, the rate of prejudgment interest is a choice of the forum court. To the extent that prejudgment interest is recoverable because defendant theoretically had use of the money, that use should be measured by the rates of interest applicable in New York. The funds were delivered by Union's correspondent bank in New York, the market for this paper was New York, and New York was plaintiff's choice of forum. The uniform practice of the Southern District in New York has been to adopt, as a matter of choice, the New York state rate of prejudgment interest and no extraordinary justification is presented in this case to justify any other measure. See Restatement (Second) of Conflict of Laws § 171, comment c (1971).

In permitting LeMay's testimony as to what he would have done if he had been apprised of the existence of particular facts, the Court recognized that LeMay would "have to be viewed as an expert witness and not as a fact witness." (Tr. 27-28). Because LeMay's expert qualifications were not established, the Court specifically invited cross-examination on the question of the competency of LeMay's testimony (Tr. 31) and suggested that it might thereafter entertain a motion to strike. (Tr. 33).

On cross-examination, it became apparent that although LeMay claimed that upon the receipt of any adverse information he would have omitted to mention an issuer of commercial paper to his customers, no such occasion had ever arisen which was even remotely analogous to the Penn Central transaction. The only occasions upon which LeMay had not passed on to a customer the name of a commercial paper issuer in the market on a particular day involved companies not rated Prime by the National Credit Office and which were local businesses selling their paper at least in part through Union Bank as agent for the issuer. (LeMay, Tr. 45). As far as major national companies were concerned, LeMay had never in any circumstances failed to pass on to a customer an available name on the ground that adverse information had come to his attention:

Q. Let me renew my question as to whether you can give me an example of an alarm that came to your attention from outside the bank other than of a company not rated prime by NCO.

A. No.

Q. No example?

A. No.

Q. To the best of your knowledge, did it ever happen?

A. Not that I know of.

(LeMay, Tr. 46-47).

On the basis of that testimony, defendant moved that the earlier responses to hypothetical questions put to LeMay during direct examination be stricken from the record. The motion -- which was taken under advisement -- was made on the ground that LeMay had absolutely no experience bearing upon the issue, and therefore could not be qualified as an expert. (LeMay, Tr. 47).

An examination of the full record of LeMay's testimony strongly supports this conclusion. LeMay's credible testimony is that he merely passed on to customers, including UHF, all of the names indicated as available by commercial paper dealers such as Goldman, Sachs. (LeMay, Tr. 63-64). Nothing in his testimony suggests that on any occasion he ever received -- much less passed judgment upon -- financial

information regarding an issuer. Accordingly, his hypothetical opinion testimony is incompetent and should be stricken. Compare Fed. R. Evid. 701, with id. 702.

In considering each of the "omissions" which are contended by plaintiff to have been material, it is respectfully submitted that materiality must be determined by the Court on the basis of the competent testimony of Goldman, Sachs' witnesses such as Vogel and Wilson whose expert qualifications are amply established on the record (e.g., Vogel, Tr. 465-469), and should not be judged by the hindsight self-serving remarks of a witness who has asserted that he performed no credit function and exercised no judgment in the transaction in question or in other similar situations.

Note with Respect to Attribution and Imputation of Knowledge

The trial evidence is clear that UHF relied heavily upon Union Bank and expected Union Bank to exercise judgment on behalf of UHF regarding the quality of commercial paper made available for purchase. In addition, it is undisputed that Union Bank alone dealt with Goldman, Sachs and that it did so as agent for plaintiff. In these circumstances any knowledge properly attributable to UHF as agent for an undisclosed principal should be imputed to plaintiff for purposes of the securities laws.

The process of imputation of knowledge to UHF involves two steps. The first step operates to impute the knowledge of agents of Union Bank to the Bank as a corporate entity. There can be no doubt, of course, that any credit analysts or other employees of the credit or investment departments of the Bank were agents of the Bank, and it is clear from the testimony of LeMay that as part of their regular business, those departments received and used The Wall Street Journal and Moody's and Standard and Poor's manuals. (LeMay, Tr. 71, 82-83). In the circumstances of this case, the contents of these common sources of financial information are properly chargeable to Union Bank personnel responsible for monitoring such matters (see Defendant's Trial Memorandum, at 98-104), and accordingly, such knowledge is attributable to the Bank. E.g., Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358 (2d Cir. 1959) (Lumbard, J.); Farr v. Newman, 14 N.Y.2d 183, 187, 199 N.E.2d 369, 371, 250 N.Y.S.2d 272, 275 (1964) (principal bound by the knowledge of his agent within the scope of his agency); Restatement (Second) of Agency §§ 272 et seq.

On March 13, 1970, Union Bank became the agent of UHF for purposes of purchasing commercial paper. In that capacity the Bank implicitly advised UHF that the commercial paper of Penn Central was a proper investment.

The Bank also acted for UHF in all aspects of the transaction relating to Goldman, Sachs. The knowledge of the Bank bearing upon that transaction was therefore attributable to UHF.

The principles involved in this second step in the attribution of knowledge are essentially the same as those set forth above. See, e.g., Restatement (Second) of Agency § 272. The mere fact that Union Bank obtained its knowledge in the course of a separate but related activity (collecting information for its own credit analysis) does not destroy the link connecting the agent's knowledge with its principal.

The Court of Appeals for the Second Circuit reached this conclusion in the Dawn Donut case, where it held that the knowledge of an agent is attributable to a principal if it is shown that the agent had duties to perform on behalf of the principal with respect to the transaction "although the agent need [not] have acquired his knowledge in connection with those duties." Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 363 (2d Cir. 1959) (emphasis added).

Applying this principle to UHF's purchase, it is clear from the testimony of Fitzpatrick (e.g., Tr. 128-30) that Union Bank had analytic and judgmental duties to perform on behalf of UHF in connection with the purchase of

Penn Central paper on March 13. Accordingly, the knowledge of Union Bank attributable to it through the receipt of relevant documentary material such as The Wall Street Journal and Moody's Transportation Manual is imputed to plaintiff.

The fact that Union Bank may not have explicitly communicated its knowledge to UHF is immaterial. This principle has recently been reaffirmed specifically with respect to the securities laws in the case of Schuiler v. The Slick Corp., CCH Fed. Sec. L. Rep. ¶ 95,065, at 97,738-39 (S.D.N.Y. Apr. 3, 1975) (Werker, J.) [citing Farr v. Newman, 14 N.Y.2d 183, 187, 199 N.E.2d 369, 371, 250 N.Y.S.2d 272, 275 (1964)]:

> "[I]t is well-settled that the principal is bound by notice to or knowledge of his agent in all matters within the scope of his agency although in fact the information may never actually have been communicated to the principal."

Unless plaintiff disavows the testimony of Fitzpatrick that he expected the Bank's "stamp of approval" on paper he purchased (Fitzpatrick, Tr. 128-30), it is difficult to see how the essential information on financial matters readily available within the Bank was not notice to the Bank and, through it, to UHF.

1. The Rogers-Vogel Conversation of February 5, 1970 Was Not Material

First among the "omissions" cited by plaintiff is the substance of a conversation between Allen Rogers of the

National Credit Office ("NCO") and Jack A. Vogel of Goldman, Sachs. Plaintiff's argument with respect to the alleged materiality of this conversation is so fragmented that it is important, at the outset, to set forth what occurred.

It is undisputed that on February 5, 1970, shortly after the 1969 fourth quarter and year-end results for Penn Central became publicly available, Rogers called Vogel to discuss the results with him. The call was not unusual because, as Vogel testified, he spoke regularly with Rogers regarding companies whose commercial paper was being offered by Goldman, Sachs. (Vogel, Tr. 530-531). Vogel testified that at the time his own opinion of Rogers and Rogers' general reputation in the financial community both for integrity and for analytic ability were high. (Vogel, Tr. 528-530). For its own argumentative purposes, plaintiff has apparently accepted and indeed adopted Vogel's testimony that Rogers' reputation and skills were of the highest order, and we assume that this is not at issue in this litigation. (See Plaintiff's Post-Trial Brief at 91-92; 102).

Vogel further testified that the substance of his conversation with Rogers is set forth in a blue sheet dated February 5, 1970 (Ex. PX-10). (Vogel, Tr. 536-37). Concededly, the blue sheet of February 5 standing alone and

without explanation of Rogers' position at NCO, his reputation in the financial community and Vogel's long standing relationship with Rogers might be subject to the interpretation that NCO was not fulfilling the independent function expected of it. In light of Vogel's understanding of Rogers' role and position, however, plaintiff's interpretation of the blue sheet memorandum is inappropriate and quite reasonably did not then occur to Vogel.

Vogel testified that in preparing the memorandum he intended only to convey that Rogers had concluded -- based upon Rogers' own independent investigation and analysis -- not to change Penn Central's Prime rating to some other rating; and that therefore the prime rating would continue since Goldman, Sachs was continuing to sell the paper. Vogel's testimony makes clear that he understood at the time that NCO did not rate paper that was not being sold, and that it was solely with reference to the question of whether or not a rating would be necessary that Rogers made his remarks. (Vogel, Tr. 540-542)*

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* Inasmuch as plaintiff has felt free to cite from the trial transcript of Franklin v. Levy, including Judge Metzner's remarks on various evidentiary issues, it may be pertinent to point out that Court's interpretation at trial of Vogel's remarks:

> ". . . . I think Vogel . . . [v]ery frankly was puffing his own canoe, making himself a bigshot,

(Footnote continued on next page)

Considering all these relevant facts, the most reasonable interpretation of the conversation and of Rogers' actions at the time is that NCO's investigation included, but was not limited to, dealer contact. Such communication could serve as a useful barometer -- as in a case where the dealer indicated doubts as to creditworthiness -- but would not be the exclusive basis for NCO's judgment.

(Footnote cont'd)

> either for his own ego or to impress the client, Goldman, Sachs has tremendous influence. That's as far as I would go with that, period.

(FSB Tr. 1098). In addition, with respect to the entire NCO issue, the Court in Franklin remarked during the course of trial:

> ". . . . I think it is immaterial . . . . if [NCO] is incompetent, or something, that's their business and it is not Goldman, Sachs' business. All Goldman, Sachs has to tell a prospective purchaser is that it is prime rated. There is no charge of a conspiracy between Goldman, Sachs and NCO to prime rate this. As I say, I do not see any issue in this case on which this bears at all. I have said it three times. I don't know how many more times I can say it. . . .
>
> If NCO is less than top drawer in making its rating, that is their problem. It is not my problem and it is not this case's problem. If NCO happens to say to Goldman, Sachs 'If you are going to continue to sell it, we are going to prime rate it,' that is NCO's problem, and I can't make it any clearer than that."

(FSB Tr. 1096-1098).

On the basis of the information available with respect to the Rogers-Vogel conversation, its background and its meaning, it is respectfully submitted that Vogel had absolutely no reason to conclude that Rogers had ignored the credit procedures which Vogel had understood him to have followed for many years, to abandon his obligation to make an independent analysis and investigation, and instead to rely exclusively upon the judgment of the dealer which sold the commercial paper in question. In light of all Vogel knew about Rogers and his practices, it would have been irrational to conclude, solely on the basis of a single reference which is at best ambiguous, that Rogers and NCO had so far abandoned all that they had stood for in the past.

And if Vogel had no reason to conclude that NCO and Rogers were derelict in their duties, then Goldman, Sachs had no information to pass on to this plaintiff of any conceivable materiality.*

---

* It should also be noted that Fitzpatrick, who made the decision to purchase Penn Central commercial paper, had never heard of the National Credit Office and in fact did not know that any company was in the business of rating commercial paper. (Fitzpatrick, Tr. 133) If in fact Fitzpatrick made the decision and to him prime meant something other than what it meant in the marketplace as a whole (compare LeMay, Tr. 60-61), then the standard use of the word prime to refer to the rating of NCO was simply irrelevant to Fitzpatrick's decision and no statement regarding it could be considered material.

* * *

After arguing generally that the Vogel-Rogers conversation is material, plaintiff engages in a lengthy and strained analysis purporting to show that the blue sheet of February 5 is admissible to show the truth of the statements made by Rogers. Each of plaintiff's arguments in that regard is considered separately immediately hereafter.

Plaintiff first argues that Goldman, Sachs has waived its right to argue for any limitation on the use of the February 5 blue sheet. (Ex. PX-10).

Far from having waived its rights, Goldman, Sachs explicitly preserved that right:

> MR. MANEY: Your Honor, this particular sheet [Ex. PX-10] is not the best example, but . . . what Mr. Rogers has recorded as having said is not objectionable in our view if offered to demonstrate that Mr. Rogers said it.
>
> THE COURT: I understand that.
>
> MR. MANEY: If it is offered to show that what Mr. Rogers said was the truth, we do object.
>
> THE COURT: I understand that, too. Do you understand that, Mr. Breindel?

(Tr. 139).

It is thus apparent that the request for a limitation was specifically asserted as to this exhibit, and indeed, plaintiff in essence acknowledges this by remarking

in its brief that the "Court was postponing a decision on GOLDMAN, SACHS' request for a limited ruling until such time as the issue needed to be resolved." (Plaintiff's Post-Trial Brief at 96).

Although plaintiff then argues that Goldman, Sachs did not use its "first opportunity" to request a limitation regarding Exhibit PX-10, it has provided absolutely no basis for its implied assertion that Goldman, Sachs was required to use its "first opportunity" to reiterate an objection which was already clearly set forth on the record. In light of the fact that the Court consistenty received material in evidence and took requests for limitations under advisement, it is submitted that the appropriate time for a determination of the desirability of a limitation as to the purposes to which this document may be put is upon receipt of post-trial memoranda from both parties. Accordingly, we next consider the merits of plaintiff's evidentiary arguments regarding Exhibit PX-10.

Plaintiff argues that Exhibit PX-10 should be admissible for all purposes (1) as a business record (Fed. R. Evid. 803(b)), (2) as a declaration against interest (Fed. R. Evid. 804(3)), and (3) under the catch-all provision of the Federal Rules of Evidence allowing other "trustworthy" hearsay evidence (Fed. R. Evid. 804(5)).

Although there is no doubt that the February 5 blue sheet (Ex. PX-10) is indeed a business record in the sense that it is admissible to show what Rogers said and what Vogel said, it is not admissible to show the truth of Rogers' assertions.

The basis for Goldman, Sachs' contention that the blue sheet statement is inadmissible derives from Rule 805 of the Federal Rules of Evidence which provides that hearsay included within hearsay is not admissible unless each part of the combined statement fits an exception to the hearsay rule. The fact that the blue sheet in question is a business record merely allows the document to be offered in evidence for the purpose of showing the truth of any statement made by Goldman, Sachs and those of its employees involved in the business which is the subject matter of the blue sheet. The statement of a person having no duty to report directly or indirectly to the author of the business record or those acting under his supervision is not admissible to show the truth of that person's statement.

In this regard, the business records exception to the hearsay rule, Rule 803(6), in essence continues the former Federal business record rule which had been codified as 28 U.S.C. § 1732. Indeed, one of the significant changes made by Congress in the Supreme Court's formulation of the

Court formulation of the Rules was to follow more closely than the proposed rules the old language of Section 1732. See J. Weinstein, Evidence ¶ 803(6) [1] (1975). Accordingly, the case law under Section 1732 is largely applicable to the current Rule.

One cogent summary of this aspect of the business record rule is contained in United States v. Grayson, 166 F.2d 863 (2d Cir. 1948). In that case, Judge Learned Hand dealt with the problem with regard to certain "sheets" which had been offered in evidence at trial:

> "Nor were the 'Sheets' within the statute making entries competent which are made in the regular course of business. True, it was part of the regular course of the dealers' business to prepare the 'Sheets'; and they were no doubt competent evidence of the fact that the dealers were offering the 'royalties' which the 'Sheets' recorded. But the 'Sheets' did not become competent evidence of the truth of all statements in them, because it was the course of the dealers' business regularly to record information which they got from others. In cases where an entrant records what he has heard, the document will be evidence of what they have told him only in case it appears that it was part of their regular course of business to report to him what the declarants themselves knew, as it was part of his business to record what they said. The statute did not mean to make competent whatever the entrant picked up from random sources, although it was part of his business to pick up information where and when he could and make a record of it. The 'act, transaction, occurence or event' which the entrant records must be one of which either he has knowledge, or which he learns from a declarant who shall 'in the course of the business

> transmit the information for inclusion in the memorandum.' 'Multiple hearsay' is no more competent now than single hearsay was before."

166 F.2d at 869 (footnotes omitted) (emphasis supplied).

The same point was made in the Ninth Circuit case, Standard Oil Co. of California v. Moore, 251 F.2d 188 (9th Cir. 1957), where the Court held:

> "A memorandum or record cannot be considered as having been made in the 'regular course' of business within the meaning of § 1732, unless it was made by an authorized person, to recordinformation known to him or supplied by another authorized person. . . [w]here the entrant or maker records information supplied by others, it must appear that 'it was part of their regular course of business to report to him what the declarants themselves knew, as it was part of his business to record what they said.'"

251 F.2d at 214 (citing Grayson). Accord, Hayes v. State, 376 N.Y.S.2d 647, 648 (App. Div. 3d Dept. 1975) (decided under state analog to Fed. R. Evid. 803(6)).

It is thus apparent that although the blue sheet may be admissible to show what Goldman, Sachs said and did and as evidence of what was said to Goldman, Sachs, it is not admissible to show the truth of a statement made by Rogers to Goldman, Sachs and recorded in a blue sheet.

Plaintiff attempts to avoid this well settled rule by suggesting -- without any basis in the record -- that NCO had an obligation to supply information to Goldman, Sachs. There is simply no evidence to support this conclusion, and in the absence of a demonstration of that proposition by plaintiff, it cannot form a basis for the admissibility of the document to show the truth of Rogers' statement.

It is also suggested that Rogers' statement qualifies as a "declaration against interest" under Rule 804(b)(3). In this regard plaintiff must persuade the Court that Rogers' statement was "so far contrary to [his] pecuniary or proprietary interest, or so far intended to subject him to civil or criminal liability, . . . that a reasonable man in his position would not have made the statement unless he believed it to be true." Plaintiff fails to demonstrate that the ambiguous record of Rogers' statement even approaches the threshhold test imposed by the declaration against interest rule now in force. The Federal Rule, codifying common law (see J. Weinstein, Evidence ¶ 804(b)(3)[01], at 804-80), deals with situations such as the case where a witness admits the existence of a debt or the ownership of property. A situation where an ambiguous statement recorded by a third party in the third party's own words merely reflects the possibility, that if construed in a certain way, the statement might subject the declarant to admonishment by his employer is obviously insufficient. See generally C. McCormick, Handbook of the Law of Evidence §§ 277, 279 (2d ed. E. Cleary 1972).

Plaintiff also argues that Rogers' statement is admissible for its truth under Rule 804(b)(5) allowing into evidence statements "having equivalent circumstantial

guarantees of trustworthiness" as the other exceptions to the hearsay rule.

The instant statement, however, bears no such guarantees of accuracy.

Plaintiff's argument that there are sufficient circumstantial guarantees of trustworthiness is circular and self-contradictory. In essence plaintiff argues that because Rogers was a man of high reputation and unquesticned integrity, it is unlikely that he would have made a false statement. Plaintiff then argues that Rogers made a statement calling into question his own high reputation and professional competence. But if Rogers' statement reflects, as plaintiff argues, a dereliction of duty, then the high reputation for integrity and professional competence upon which plaintiff relies must have been erroneous. Plaintiff cannot have it both ways: either Rogers was a man of unquestioned integrity who would not have been derelict in his duty or Rogers was a man who would have been derelict in his duty, in which case the reputation is undeserved and does not provide the circumstantial guarantees of trustworthiness that plaintiff asserts.

* * *

Plaintiff also argues that regardless of whether the blue sheet of February 5 is admissible for the truth of

the statement made by Rogers, the mere fact that the statement was made is a material fact which should have been disclosed. Plaintiff again argues that LeMay's testimony that he would not have purchased the paper had he been aware of the statement, demonstrates materiality. As indicated earlier, LeMay's testimony in this regard is incompetent and should be stricken. Moreover, as previously indicated, Vogel had no reason to believe that the statement made by Rogers indicated that -- contrary to his understanding of Rogers' longstanding practices -- he had chosen to rely on Goldman, Sachs to the exclusion of making an independent analysis. Having no reason to believe that NCO had adopted such a course, Vogel had no reason to communicate the substance of the conversation to investors.

2. No Facts Known or Knowable to Goldman, Sachs Regarding the Existence or Availability of Bank Lines Were Required to be Communicated to Plaintiff

Bank lines of credit, which indicate a willingness to lend money in certain circumstances, are often a requisite of good financial planning by an issuer. Because the commercial paper market may contract as a result of general monetary conditions which have no bearing on the creditworthiness of a particular issuer, the issuer may have difficulty continuing to roll-over the amount of commercial paper it wishes to keep outstanding. If an issuer's cash

plans are based upon a constant level of outstandings, such a temporary decline or "run-off" would require it to seek cash from other sources to carry on its normal business. One source of cash in such circumstances may be bank lines of credit available for use upon request. (See LeMay, Tr. 97). Other sources might include the arrangement of a loan at the time of the run-off, a drawing down of compensating balances on a temporary basis, a diversion of revenues on a temporary basis or a sale of assets. (E.g., Wilson, Tr. 922-23). In some cases a combination of bank lines and other means of raising cash are contemplated in the event of a temporary run-off.

As shown in Point III, Penn Central's financial plans contemplated the use of banklines in combination with other means of raising cash when needed. No competent testimony or other evidence was adduced at trial tending to show that those plans were inappropriate or that 100% bankline coverage was desirable for credit reasons for Penn Central.

Neither UHF nor Union Bank made any inquiry with respect to bankline coverage -- as they made no inquiry with respect to any matter regarding the financial condition, plans or arrangements of Penn Central. (LeMay, Tr. 92, 94; Fitzpatrick, Tr. 132). It is apparent from the testimony at trial, moreover, that bankline coverage was an item that

loomed large only in plaintiff's hindsight view of Penn Central and that it had absolutely no importance at the time of the investment.

During the cross-examination of LeMay the Court established that banklines are without credit significance in any situation where a company's financial condition has deteriorated to the point where it is unable to obtain cash by other means:

Q. Isn't it a fact, Mr. LeMay, that the line of credit is extended on the condition that the bank continue to be satisfied with the credit worthiness of the potential borrower?

A. Undoubtedly, yes.

* * *

THE COURT: Let me be sure I understand it. I think I do, but I never thought there was any doubt about it.

Tell me if there is any doubt about it. Even [if] a bank authorizes a line of credit whether in writing or otherwise, let's assume in writing, to a customer, and let's assume for $1,000,000 for three months or six months, if the bottom falls out of the business of that customer in the second month the bank does not consider itself legally obligated to continue lending, does it?

THE WITNESS: That is correct.

THE COURT: Or if in the judgment of the bank there is substantial reason caused by change of conditions, then the bank would feel both legally and morally free to change its mind, wouldn't it?

THE WITNESS: Correct.

(LeMay, Tr. 55-57).

It is thus undisputed that banklines are likely to evaporate at the very time when they are needed for credit reasons, and that if a company is not creditworthy the theoretical existence of such lines is of no assistance. On the other hand if a company is creditworthy, then by definition it has other means of raising cash, and banklines, if not superfluous, are at least not required.

* * *

Beyond what is indicated above, Goldman, Sachs' position with regard to the significance of banklines is set forth in Point III. Accordingly, the remainder of this section of defendant's memorandum will only address the few additional arguments plaintiff makes in its "omissions" section and which purportedly bear upon an issue of "materiality" which plaintiff has attempted to segregate from the question of whether or not banklines are of credit significance.

Plaintiff in part asserts that the testimony of its own witnesses establishes the materiality of banklines.

See Plaintiff's Post Trial Brief at 113-114. An examination of the testimony of LeMay and Fitzpatrick indicates, however, that the sum total of the credible evidence offered by them is that banklines were immaterial to them and to investors in their position.

As far as Fitzpatrick -- the man who claims to have made the decision to purchase Penn Central commercial paper -- was concerned, banklines were apparently as irrelevant as every other possible standard:

> Q. Did you ever convey to [Union Bank] any standard or criterion of any kind apart from the fact that you wanted prime rated paper?
>
> A. No, prime in the sense of complete safety.
>
> Q. You never told them you wanted any particular bankline coverage, is that right?
>
> A. Yes, sir, that is correct.

(Fitzpatrick, Tr. 132).

LeMay's testimony is somewhat more complex and substantially less credible. After recognizing, as indicated above, that banklines do not assure the payment of commercial paper when due, LeMay nevertheless insisted that 100% bankline coverage is significant. Indeed, LeMay asserted that "[b]asically quality companies were covered completely. At least 100% coverage of banklines was the normal accepted practice by most issuing agents." (LeMay, Tr. 32)

It appeared during cross-examination, however, that Mr. LeMay hadn't the slightest idea whether so-called "high quality" companies had 100% bankline coverage:

Q. Returning to the question of bank line coverage, is it your testimony that 100 per cent bank line coverage of commercial paper outstanding was the practice, is that right?

A. General practice.

Q. For what you call high quality companies?

A. Yes.

Q. Do you know whether or not General Motors Acceptance Corporation has 100 per cent bankline coverage, had at that time?

A. I don't know.

* * *

Q. Would you consider it a high quality company?

A. Yes, sir.

Q. How about Ford Motor Credit Company?

A. The same thing.

Q. You don't know whether or not they have 100 per cent line coverage?

A. That is true.

* * *

Q. What about Sears, do you know whether Sears, Roebuck Acceptance Corporation

had 100 per cent line coverage at the time?

A. I don't know.

Q. I take it you think it a high quality company too?

A. Yes.

Q. The same with . . . Ford?

A. Yes.

(LeMay, Tr. 90-93). As the later testimony of George Van Cleave shows, none of the companies about which LeMay was questioned had 100% bankline coverage, thus undercutting the credibility of LeMay's general remarks regarding 100% bankline coverage, his pretensions to expert competence in this area and his assertions regarding the significance of lack of 100% bankline coverage in the case of Penn Central.*

Finally, to conclude the question of LeMay's claimed view of the importance of banklines, it emerged that the issue was never of any importance to him:

Q. In the course of all the transactions you handled for customers of the bank, you never asked a dealer what the line coverage on an issuer was?

---

* Van Cleave testified that the banklines of the companies mentioned were approximately as follows: GMAC, 30%; Ford Motor Credit, 25%; Sears, Roebuck Acceptance, 85%. (Van Cleave, Tr. 248).

A. No, sir.*

(LeMay, Tr. 96).

Plaintiff's other points in support of the proposition that banklines are material are summarized by plaintiff as follows:

> (a) 'that many of GOLDMAN, SACHS' sophisticated and professional investors wanted only commercial paper that had 100% bankline coverage";
>
> (b) "that most of GOLDMAN, SACHS' issuers had 100% bankline coverage"; and
>
> (c) "that in early February, 1970 GOLDMAN, SACHS believed that PENN CENTRAL's failure to increase its bankline coverage from 50% to 100% would result in a run-off estimated to range between 25% to 50% of their outstanding paper . . . ."

(Plaintiff's Post Trial Brief at 113). Each of these arguments will be considered in turn.

(a) It is uncontroverted that many of Goldman, Sachs' investor-customers -- indeed, an increasing number -- desired to purchase commercial paper having 100% bank-

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* LeMay's testimony leaves no doubt, however, that Union Bank was capable of acquiring such information if they desired it:

> Q. How would you get that kind of information [regarding bankline coverage] if you wanted it?
>
> A. Our senior people if they went directly to them to establish a line then would obtain it.

(LeMay, Tr. 92). The simple fact is, however, that no one in Union Bank ever thought the matter sufficiently important to make any inquiry regarding it in connection with commercial paper transactions.

line coverage. Goldman, Sachs became aware of the existence of such customers, of course, when such customers communicated that criterion to Goldman, Sachs' commercial paper salesmen. And, quite naturally, such customers were not shown the commercial paper of issuers not having 100% bankline coverage. Neither UHF nor Union Bank, however, had such a requirement and the matter of bankline coverage was never raised during the course of discussions between Mr. LeMay and Goldman, Sachs.

To assert, in retrospect, that an unspoken criterion selectively imposed by certain other investors was material is both unfair and misleading. For example, there are many investors in the short-term money market which only buy the commercial paper of finance companies. To those investors the question of whether a particular issuer is a finance company or an industrial company is obviously material. But if a customer merely requests that he be shown commercial paper and is not told that a particular issuer is a finance company or an industrial company he has no cause to complain, and the fact that certain investors purchase only paper of finance companies does not make that fact material to the class of investors who purchase both industrial and finance paper without distinction. The requirement of 100% bankline coverage is the same. It is, quite

simply, the kind of criterion that must be communicated in order that the dealer may know whether or not it is significant to the particular investor. And there is no doubt that no such communication existed in this case.

(b) Plaintiff also urges that 100% banklines were material because most of Goldman, Sachs' issuers maintained such coverage. In this regard it should be noted that Wilson testified that not all Goldman, Sachs' issuers had 100% commercial paper coverage, and cited as examples of other companies not so covered several subsidiaries of AT&T which issued commercial paper through Goldman, Sachs. (Wilson, Tr. 870).*

In addition, companies without the enormous saleable assets that Penn Central controlled were in a significantly different position regarding their ability to raise cash to pay maturing commercial paper. Accordingly, the need of such companies to have full bankline coverage as an aspect of general financial planning was greater than it was for Penn Central. This is precisely the point which O'Herron made to Wilson in the conversation recorded in the blue sheet of September 19, 1969 (Ex. PX-20), which is discussed by plaintiff at pages 106-107 of its Post-Trial Brief.

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* George Van Cleave's uncontroverted testimony also confirms that there were other financial and industrial companies with less than 100% line coverage. (Van Cleave, Tr. 247-48).

In short, plaintiff has not shown that the practice of certain other issuers regarding backline coverage renders Penn Central's coverage a material fact.

(c) Plaintiff's next argument for the materiality of banklines is based upon Wilson's statement to O'Herron on February 5, 1970 that if bankline coverage were not increased a "runoff" could be expected to result once the 1969 results became widely known. (See Ex. PX-11).

The simple answer to this argument is that Penn Central did not obtain additional bankline coverage and yet there was no significant decline in commercial paper outstanding. (See Ex. CW, column 1 for period February 5, 1970 through March 16, 1970).

In addition, the effort to obtain 100% bankline coverage had been going on for some time because of Wilson's view that an increase in line coverage would improve the marketability of Penn Central commercial paper. (See, e.g., Wilson, Tr. 887).

As Wilson explained, he used the 1969 year-end losses and the risk of a "runoff" "as a wedge, if you will, to negotiate with them, to get tough with them." (Wilson, Tr. 877). Wilson's statement on February 5 cannot be taken out of the context in which it was made and which establishes that the statement was part of an evolving process of

negotiation. It was not -- as plaintiff seems to suggest -- an abstract remark on the legal issue of materiality.

Plaintiff concludes its consideration of banklines by arguing that bankline coverage is material because it can provide "safety" to commercial paper holders. Certainly in some circumstances the existence of some banklines to provide turnaround room to sell liquid assets is useful, but plaintiff's arguments confuse the existence of some banklines with the existence of 100% bankline coverage. Moreover, the fact that nearly all of Penn Central's $100,000,000 in banklines were in fact made available by banks does not -- as plaintiff asserts -- show that banklines were available even in difficult times and do therefore provide a margin of safety. This merely shows that the banks in question, like Goldman, Sachs, continued to believe that Penn Central was creditworthy until long after the date of plaintiff's purchase and the dissemination of significantly more adverse news regarding Penn Central's financial condition.

Plaintiff also argues that Penn Central itself took the view that banklines were the equivalent of assets which could be liquidated to pay commercial paper indebtedness. The quoted language which appears on page 116 of plaintiff's brief, however, only states that such loan commitments provide "reasonable assurance" that applicant will

be able to meet commercial paper maturities. "Reasonable assurance" is not the equivalent of an immediately saleable asset. Plaintiff hardly buttresses its argument by citing the Report of the Interstate Commerce Commission which refers to the existence of $100,000,000 in backup lines and notes that Penn Central has other assets apart from banklines "which can be liquidated to cover maturing commercial paper notes". (Ex. PX-67) The conclusion of the I.C.C was thus the same as Goldman, Sachs: the availability of liquidatable assets makes 100% line coverage unnecessary.

Finally plaintiff complains that Penn Central's financial statements carried the amount of commercial paper backed by banklines as long term debt, thus supposedly demonstrating that Penn Central itself viewed the bankline commitments as assured. Apart from the fact that this accounting treatment was required by the I.C.C. (Wilson, Tr. 1021-22), plaintiff fails to note that the amount carried as long-term debt was not $100 million but $50 million -- that amount being the portion of the written and binding Revolving Credit Agreement set aside for commercial paper purposes. (Ex. PX-60). It is undisputed that such a revolving credit agreement in writing is a binding contract; and it was for this reason that the $50,000,000 commitment it represented was carried, consistent with I.C.C. accounting principles, by

Penn Central as long-term debt. (See Ex. PX-39, at 2). It has never been asserted by plaintiff or by anyone else, however, that it was the practice in the industry or was in any way necessary or desirable that a commercial paper issuer have its outstandings backed 100% by binding written unalterable commitments such as a revolving credit agreement. Hence the accounting treatment of the revolving credit agreement is totally irrelevant, and plaintiff's confusion of the $50 million backup lines and the $50 million portion of the revolving credit agreement reflects either a significant misunderstanding of the nature of the financial condition of Penn Central or a disingenuous effort to complicate further an already complex situation.

3. No Facts Regarding Goldman, Sachs' Inventory Were Required to be Communicated to Plaintiff

Plaintiff's overall contention with respect to Goldman, Sachs' decision to reduce its inventory of Penn Central commercial paper is that such actions are evidence that Goldman, Sachs was not acting in good faith in continuing to sell the commercial paper to investors including UHF. Point I of this memorandum showed that the reduction of inventory was made for sound business reasons totally unrelated to Goldman, Sachs' view of the creditworthiness of Penn Central. Because the inventory reduction was a

business decision relating to internal cost factors, it did not bear upon Goldman, Sachs' motives or state of mind at the time of purchase and there was no reason why it should have been communicated to UHF.

The bulk of plaintiff's discussion of inventory in its section on "omissions" consists of several challenges to Goldman, Sachs' arguments regarding the business justifications which were the motivating cause of Goldman, Sachs' inventory reduction and imposition of an inventory limitation in February of 1970.

Plaintiff first argues that limitations upon the size of inventory of various finance companies are irrelevant to show that the Penn Central limit was part of a pattern. The sole basis for plaintiff's argument appears to be that the other companies upon which a limitation was placed were finance rather than industrial companies. Plaintiff offers no explanation of why it finds that distinction significant, and indeed it appears to have no significance except in the view of an advocate seeking at all costs to prove that the Penn Central inventory limitation was unique in the history of Goldman, Sachs. The testimony of Van Cleave, by contrast, shows that the finance company limitations reflected in Exhibit BM were precisely analogous to the inventory limitation or target imposed in the case of Penn Central:

Q. Mr. Van Cleave, could you explain what Exhibit BM for identification is?

A. Yes, this is a memo to establish internal guidelines on the inventory of certain of our commercial paper issuers, in this case finance companies.

* * *

Q. Why finance companies?

[Objection by Mr. Breindel overruled]

A. Because finance companies were a natural for a ceiling because they were in the market as I mentioned before, constantly. They were always in the market and therefore we were helping to finance their position.

THE COURT: They were the friskiest horses in the corral and you wanted to put a muzzle on them first?

THE WITNESS: Not risky --

THE COURT: I said frisky.

THE WITNESS: Absolutely.

* * *

Q. Mr. Van Cleave, were there any frisky industrial issuers?

A. Yes, there were.

Q. Can you name one?

A. Penn Central was one.

Q. Were there others?

A. Yes. There were three or four other companies that we were experiencing the

> same problem in that we always had large positions in inventory and we were doing everything we possibly could to get them to establish swing lines. So we did then establish internal guidelines as far as their inventory positions were concerned.

(Van Cleave, Tr. 313-315). It is thus apparent that the finance company target limitations reflected in Exhibit BM provide an example of prior consistent activity not undertaken in response to any particular information regarding creditworthiness or the financial status of the companies in question, and that limitations or targets were in fact imposed for business purposes unrelated to such matters.

Defendant also presented evidence that a reduction in the size of Goldman Sachs' inventory of Penn Central itself had occurred in December of 1969. Again plaintiff argues that the incident is distinguishable and therefore irrelevant. Without examining each of the plaintiff's purported distinctions (see Plaintiff's Post-Trial Brief, at 120), suffice it to say that the entire premise of plaintiff's argument is untenable. Plaintiff argues in essence that because the inventory reduction in February was a response to bad financial news, it is unlike any other inventory reduction that may be shown. That argument, however, is circular. In point of fact, as demonstrated in Point I, the two inventory reductions were very much alike

and were made for very much the same reasons. Accordingly, it is the adverse financial news which was irrelevant to the decision and not the cost motivation underlying both the February and the December inventory reductions.

Plaintiff next argues that Goldman, Sachs itself viewed the inventory reduction as material in that Wilson agreed with O'Herron that the inventory buyback should not occur prior to the attempt to obtain additional lines of credit from Penn Central's banks. Plaintiff here has utterly confused two separate groups of banks and has also made another factual misstatement of rather substantial significance. (Plaintiff's Post-Trial Brief, at 121-22). First, it should be noted that O'Herron had never expressed any intention of going to the banks which were part of the backup line of credit in order to obtain additional lines or loans. Rather he intended to and did in fact go to various New York and other money center banks which were participants in Penn Central's revolving credit agreement. Plaintiff is apparently confused by Wilson's reference to an offer by O'Herron which had been made sometime prior to the earnings announcement to use the Revolving Credit Agreement to reduce inventory. (See Ex. PX-11).*

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* The reference to that earlier conversation again confirms that a reduction in inventory by activation of banklines was contemplated before the 1969 earnings were announced and was not simply a reaction to adverse financial news.

In any event, there is nothing controversial in O'Herron's observation that, in a period of tight money when credit was being allocated very stringently, it would not be tactically advantageous to borrow $10 million from the very banks from which one was seeking an additional loan commitment on the same day. This is not a matter of concealment but simple psychology. Wilson had no reason to believe that the sophisticated banks in question would lend additional money without making an appropriate credit investigation which would certainly include a review of total commercial paper outstanding as well as bank lines in use. And nothing in the record suggests any conspiratorial attempt to conceal that or any other matter from Penn Central's banks.

Plaintiff's-Post Trial Brief continues with the following assertion which contains another more serious factual error:

> "Accordingly, the WILSON-O'HERRON strategy was to not alert the banks of GOLDMAN, SACHS' concern for PENN CENTRAL's financial condition and to have PENN CENTRAL repurchase its commercial paper after the banks had given (or refused as was the case) PENN CENTRAL additional banklines."

(Plaintiff's Post Trial Brief, at 121-122) (emphasis added). Contrary to plaintiff's statement, the uncontroverted testimony of several witnesses and a number of documents attest

to the fact that Penn Central did indeed obtain $50 million of additional bank lines for its wholly-owned subsidiary Pennsylvania Company in early February of 1970. (E.g., Ex. PX-23; Sullivan, FSB Tr. 864-65). This is precisely what Penn Central had sought to do and what it was able to accomplish on very short notice in a period of extremely tight money. Far from showing the lack of creditworthiness of Penn Central, this accomplishment demonstrates one aspect of its continuing access to credit -- through its wholly-owned subsidiary which indisputedly obtained the money for the disclosed purpose of lending it "upstream" to the transportation company. (Sullivan, FSB Tr. 873-74).

Finally, plaintiff argues that if cost factors and other business considerations were really the basis for Goldman, Sachs' decision to reduce Penn Central inventory, then it would not have imposed a temporary ceiling and made the continuation of that limitation dependent upon the financial condition of Penn Central. (Plaintiff's Post Trial Brief, at 124). Contrary to plaintiff's position, however, Goldman, Sachs' policy in this regard was entirely consistent. An improved financial condition of Penn Central -- as reflected in the satisfaction of the requirements set forth in Wilson's blue sheet of March 23, 1970 (Ex. PX-14) -- would necessarily have improved the marketability of the paper,

thus allowing inventory to decline naturally to a lower level and making the imposition of any particular ceiling unnecessary.*

In sum, plaintiff's challenges to the legitimacy of Goldman, Sachs' inventory reduction in February of 1970 do not rebut the persuasive, consistent and logical explanation set forth in Point I.

4. No Facts Regarding the Activities of Brown Brothers Harriman & Co. Were Required to be Communicated to Plaintiff

It is uncontroverted that Brown Brothers Harriman & Co., a private commercial bank in New York City, had, prior to February 5, 1970, purchased substantial quantities -- amounting to as much as 15%** of the outstandings -- of Penn Central Transportation Company commercial paper. (See Ex. CU). It is also undisputed that Goldman, Sachs was informed on February 5, 1970 that Brown Brothers had "temporarily" removed Penn Central from its approved list of commercial paper issuers (Ex. PX-12). Although the blue sheet

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* Goldman, Sachs continues to object to the admission in evidence for any purpose of Exhibit PX-14, written ten days after plaintiff's purchase of its Penn Central Transportation Company commercial paper note and which does not, on its face, or by way of any testimony adduced at trial refer back to the relevant time period.

** It is not clear whether the 15% refers to a level of outstandings of $100 million, $150 million or $200 million.

February 6, 1970 is only hearsay evidence of the fact that Brown Brothers had in fact removed Penn Central's name from its approved list, it can be established from Exhibit CU that Brown Brothers did not thereafter purchase Penn Central Transportation Company commercial paper. Apart from these facts, however, the record is barren of any information regarding the incident. There is no indication of why Brown Brothers Harriman made the statement to Goldman, Sachs or why, if true, it had in fact removed Penn Central from its approved list.

Plaintiff, then, has failed to demonstrate that the statement made was of any significance. As Vogel testified, investors regularly take names on and off approved lists, and the mere fact that Brown Brothers had done so was not, in his expert judgment at the time, a matter of credit significance. (Vogel, Tr. 545-46).

Vogel recognized, of course, that if the name had been removed from an approved list by a knowledgable bank for credit reasons, that might be a fact of some significance. The evidence however does not support any such proposition. On the contrary, the fact that Brown Brothers continued to maintain its back-up line of credit for the benefit of Penn Central undercuts any notion that the removal of Penn Central from its commercial paper approved list was of

credit significance. (Vogel, Tr. 546-47)* Because it is established that a line of credit is cancellable if the lender is dissatisfied with the financial condition of the issuer (Sullivan, FSB Tr. 876; LeMay Tr. 55-57), Brown Brothers' willingness to lend money to Penn Central in the Spring of 1970 after the date of the UHF purchase shows the insignificance of its removal of Penn Central from its approved list.

The non-materiality of Brown Brothers' action is further demonstrated by the fact that total commercial paper outstandings remained high during the early spring of 1970

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* Plaintiff relies upon the conclusion reached by Judge Metzner that the Brown Brothers Harriman incident was of significance. (Plaintiff's Post-Trial Brief, 128 n.*) It should be noted in this regard that that Court's treatment of the Brown Brothers' issue is a major ground upon which Goldman, Sachs moved to amend the judgment or for a new trial in the Franklin litigation. Judge Metzner stated during the course of trial that he would not hear further evidence on the Brown Brothers' issue because he felt it was without significance. When plaintiff's counsel in Franklin continued to press the point, Judge Metzner stated "I don't know what you are going through it for. I am not going to give it any weight." (FSB Tr. 541). Goldman, Sachs has pointed out in its post-trial motion papers in Franklin that it would have argued, on the basis of the Franklin record, that the alleged removal of Penn Central from Brown Brothers' approved list was insignificant because Brown Brothers itself lent $2,000,000 of its own money to Penn Central on an unsecured basis not legally or practically different than a commercial paper note on April 30, 1970. (Lepley, FSB Tr. 949-50). The date April 30 is significant because it was approximately one week after the announcement of Penn Central's first quarter results which were far more adverse than the year-end results announced in February.

up to and past the date of UHF's purchase. Thus, although an investor which had purchased up to 15% of the total amount of commercial paper outstanding was no longer in the market, the market itself was sufficiently resilient to absorb virtually all of the paper that Brown Brothers might otherwise have purchased.

In sum, plaintiff has failed to demonstrate that Brown Brothers' action was of credit significance or that there was any reason why UHF should have been told of the fact that some other investor, not shown to be in any superior position, decided to make some other investment rather than Penn Central. In this regard, the remarks of Judge Metzner directed to plaintiff's counsel in Franklin are particularly pertinent:

> "Why didn't you bring Brown Brothers here to tell me why they did it? . . . [T]here was no trouble in selling their paper during that period, was there? . . . You haven't indicated anything to the contrary. There is nothing in the record that indicates anything to the contrary."

(FSB Tr. 1275-76).

The record in the instant case is equally barren of relevant evidence on the issue.

5. No Facts Known or Knowable to Goldman, Sachs Regarding Past or Future Earnings, Cash Position or Working Capital Were Required to be Communicated to Plaintiff

Because UHF and its agent Union Bank are corporations, what was known by them turns upon what was known or

can reasonably be assumed to have been known to their agents. Notwithstanding Mr. LeMay's unwillingness to admit that he had read any of The Wall Street Journal articles which were shown to him,* he conceded that he read The Wall Street Journal regularly in connection with his work at the bank. (LeMay, Tr. 71). That fact is a sufficient basis for imputing to Union Bank and through it to UHF knowledge that LeMay would reasonably have obtained from his reading.

Based upon LeMay's testimony of his usual practices in reading the financial press and upon the general principles of law set forth earlier,** it is thus possible to reconstruct what UHF should be treated as having known at the time of its Penn Central purchase. Furthermore, although it is quite possible that -- as he testified -- LeMay did not in fact remember having read particular Penn Central articles, the contents of those articles were widely disseminated public knowledge and, for that reason as well, Goldman, Sachs was under no duty to disclose them.

i. Earnings Trends

Since the merger of the Pennsylvania Railroad and the New York Central in 1968, the earnings of the combined company, particularly railroad operations, had been in a

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* Exs. H, A-182, A-195, AB, A-180 and A-187.

** See Defendant's Trial Memorandum, at 96-104.

period of decline. The trend of the decline was discernible at the time from contemporaneous newspaper accounts of Penn Central's year-end and quarterly earnings.

LeMay acknowledged that he was aware from his reading of The Wall Street Journal that there had been a merger of the New York Central and Pennsylvania Railroads, that it was the hope of the architects of the merger that substantial savings would occur, that it might take some time for those savings to take effect and that during the time period here in question, Penn Central continued to suffer operating losses. (LeMay, Tr. 71-73, 78).

Turning to the specific articles which LeMay must have read if he adherred to his stated reading practices, LeMay -- and therefore Union Bank and UHF -- knew that earnings from railroad operations for the year 1968 had declined $14 million from the previous year and that railroad operations showed a $2.8 million deficit as compared with a net income of $11.5 million from the previous year. (Ex. H, The Wall Street Journal, January 31, 1969)

Exhibit H is one early reflection of a trend which is apparent from a review of subsequent articles in The Wall Street Journal. It was followed on April 24, 1969 by another article describing the results of the first quarter of that year. The article carried the headline "PENN CENTRAL PROFIT PLUNGED IN FIRST QUARTER." (Ex. A-211).

Not only does the article make clear that Penn Central was in a down-trend, but it also shows the extent to which that trend was attributable to the results of rail operations. The two sub-headlines announced "Consolidated Earnings Fell 66% on Increased Revenue; Railroad Losses Blamed" and "Net of Subsidiaries Soared". Anyone reading the article could readily see, then, that all portions of the Penn Central complex except the Railroad were improving their profitability, but that even this improvement was insufficient to offset the "heavy losses in its Railroad operations" which "resulted in sharply lower first-quarter net income for Penn Central." (Ex. A-211)

Second quarter 1969 results were reported in late July and showed that the trend continued. The headline of a July 29th article (Ex. AB) announced "PENN CENTRAL PROFIT FELL 7.5% IN QUARTER; RAILROAD SYSTEM HAD LOSS".

The third quarter of 1969 followed the trend set in the preceding quarters, and is reflected in another prominent Wall Street Journal article, dated October 21, 1969 (Ex. A-195). This article reported losses for both the third quarter and the nine-month period and showed substantial declines from the comparable periods in the previous year. The headlines disclose most of the story:

> "PENN CENTRAL REPORTS LOSS IN THIRD PERIOD
> Deficit from rail system swells to $19.2 million, nine months net plunges"

Given a decline at year-end 1968 and an increasing decline in each of the first three quarters of 1969, the announcement of a loss for the fourth period and for the year 1969 was not inconsistent. LeMay, of course, denied any recollection of having read the newspaper article which appeared on February 5, 1970, announcing both a fourth quarter and full year loss. (Ex. A-182). The article also recorded the fact that there had been a $126 million write-off of certain transportation facilities, and gave substantial information regarding Penn Central's results on both a consolidated and unconsolidated basis. The headline could hardly have been clearer:

> "PENN CENTRAL HAD $13.2 MILLION 4TH PERIOD LOSS
> Operating net for full year fell 95%; firm writes off $126 million of rail service."*

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* Plaintiff claims that there was a significant disparity between O'Herron's prediction to Wilson that earnings would be "in the black" for the fourth quarter (PX-33 (A-81)) and the actual results, as reported on February 5, 1970. As previously explained, Goldman, Sachs did not view the disappointing results for the fourth quarter in this light. O'Herron and Bevan had adequately explained the reason for the additional loss at the February 6 meeting, and Goldman, Sachs reasonably accepted that explanation. Even if, however, it is significant that a fourth quarter profit was predicted and none materialized, both the prediction and the result were public knowledge. The Wall Street Journal article of October 21, 1969, recording third quarter earnings (Ex. A-195), had quoted Stuart Saunders, Chairman, as follows:

(Footnote continued on next page)

The consistently declining profits of Penn Central, both on a consolidated and an unconsolidated basis, must have been obvious to anyone who cared to examine the public record. To deny in these circumstances that plaintiff through its agent had knowledge of this trend would be to allow a sophisticated financial institution such as Union Bank to ignore common public knowledge.

Whether it is held that such information is known to plaintiff or that the lack of communication of such public information is in any event immaterial, the fact remains that Goldman, Sachs should not have been obliged to communicate what Mr. LeMay could and certainly did read for himself in the financial press. This was precisely the point made by the Court of Appeals in Frigitemp Corp. v. Financial Dynamics Fund, 524 F.2d 275, 282 (2d Cir. 1975), where it stated that a defendant's "reasonable belief that the other party already has access to the facts should excuse him from new disclosures which normally appear to be repetitive."

(Footnote cont'd)

> "The executive said he expects 'much better results' for the railroad system in the fourth quarter. 'Traffic volume during the last two weeks in September and so far in October has been excellent, exceeding forecasts and setting post-merger records in several categories,' he said. 'If this level of traffic is sustained we should be able to show much better results for the fourth quarter.'"

The question of what needed to be communicated with respect to earnings results and prospects does not, however, end with the recognition that Union Bank (and through it UHF) knew the existing trend of losses. Goldman, Sachs also knew -- and plaintiff concedely did not know -- that Penn Central Transportation Company was projecting an unconsolidated loss of $56 million for the year 1970. (See Ex. PX-11 (A-71)).

As previously shown, Goldman, Sachs weighed this projected loss for 1970 with all the other information at its disposal and concluded at the time that Penn Central was creditworthy. On that basis it continued to sell the commercial paper of Penn Central.*

Even if -- contrary to LeMay's own expectations at the time -- this fact is now taken out of the context of Goldman, Sachs' credit analysis and is separately considered, it is in any event not "material" in light of the information already at LeMay's disposal.

Materiality is necessarily determined in part in light of what the investor already knows. See, e.g., Rogen v. Ilikon Corp., 361 F.2d 260, 266 (1st Cir. 1966).

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* Goldman, Sachs' conclusion that Penn Central remained creditworthy despite the projected loss is confirmed by the parallel judgment of Penn Central's banks, based upon the same information and upon documentary support thereof. (Sullivan, FSB Tr. 864-65, 873-74).

Since it was public knowledge that Penn Central had consistently announced increasingly poor results and had shown a steady decline in railroad operating results, no reasonable investor had any basis for believing that 1970 would show a reversal of that trend. Nothing in the publicly available information suggested such a reversal and LeMay and Fitzpatrick certainly indicated no expectation that one would occur. Since the loss for 1969 had been $56 million on an unconsolidated basis, a projected loss for 1970 in the same amount would have represented a leveling-off of the operating results which -- on the basis of the trend reflected in publicly available information -- might otherwise have been expected to continue to decline. Accordingly, the projection for 1970 cannot be considered material in light of what was already known.

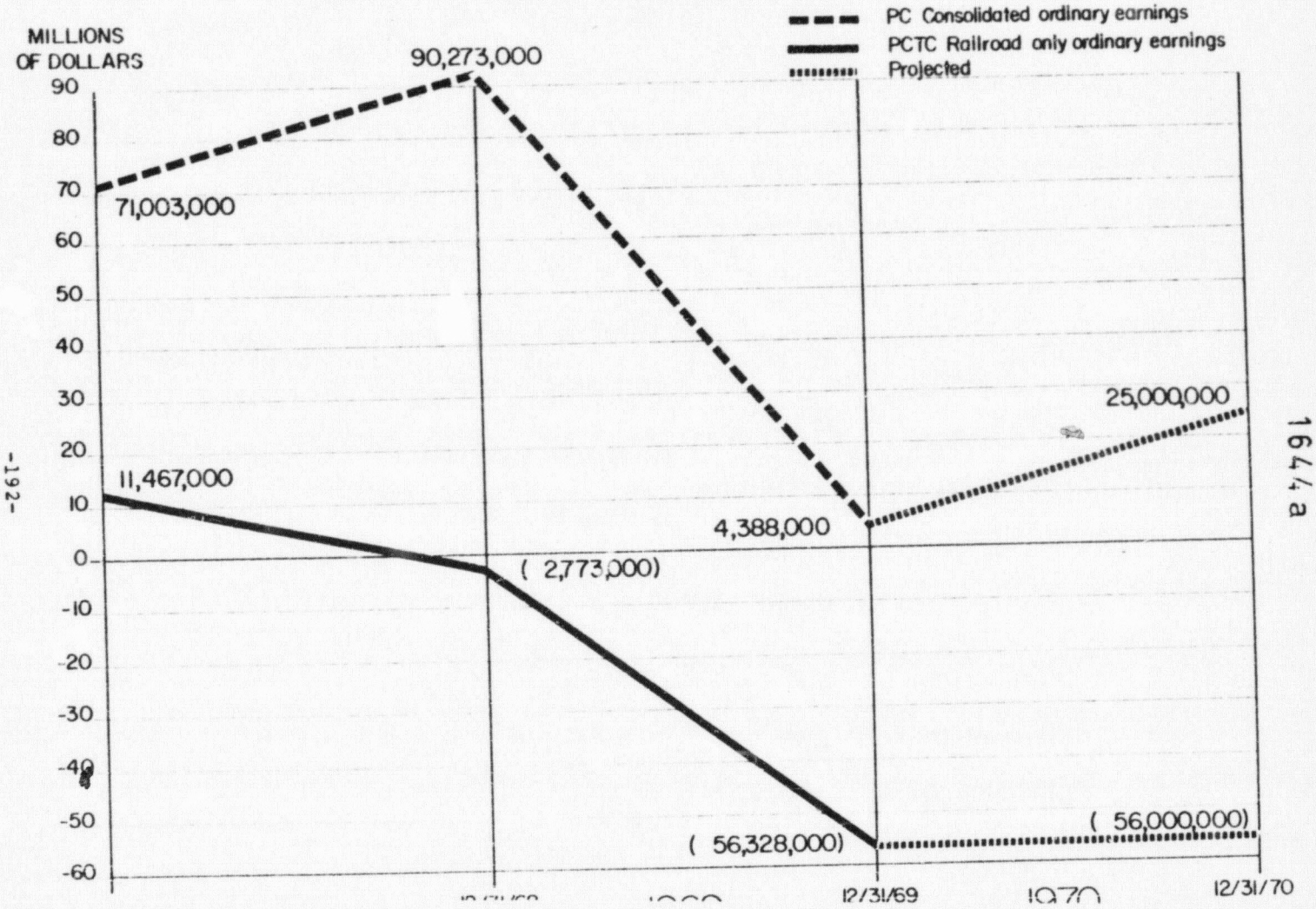
Put another way, if earnings and losses are to be considered a factor at all in the investment decision of a reasonable man in the position of plaintiff, then the knowledge of such earnings and losses from public sources was sufficient to show a trend of losses. Knowledge of that trend makes the projected continuation of losses at the same level immaterial.

In addition, placing the loss projection in the context in which Goldman Sachs learned it, it can be seen

that the February 6 blue sheet (Ex. PX-12 (A-69)) also reflects a projected profit for Penn Central on a consolidated basis of $20 to $25 million -- up from $4 million dollars in 1969. The total picture, then, was of a stabilized loss from railroad operations and an increasing profit overall.

The immaterial nature of the 1970 projections is also demonstrated graphically by the chart on the following page. Therein the consolidated earnings from 1967 through 1969 are graphed, having been taken from the 1967 and 1968 annual reports (Exs. A-21 and A-21a) and from The Wall Street Journal of February 5, 1970 (Ex. A-182). The figure for earnings for PC Consolidated and PCTC Railroad-only both reflect income from ordinary operations excluding extraordinary charges. The dotted lines reflect the 1970 projections given to Goldman, Sachs on February 6. The projections show a favorable change from the clear trend of the prior consolidated earnings and railroad earnings. Thus, to the extent that material information in this context is adverse information, the 1970 projections were clearly immaterial.

PENN CENTRAL EARNINGS



164 a

ii. "Tight Cash"

A second set of facts which plaintiff claims should have been communicated to it involved Penn Central's so-called "tight cash" position during 1969 and 1970. By this plaintiff apparently refers to several vague statements that cash was "tight" (See, e.g., Ex. PX-11 (A-71)) and to one specific comment that Penn Central required $170 million in financings during 1970. (See Ex. PX-12 (A-69)).

Beginning as early as February 1969, the press had reported planned borrowings by Penn Central indicating its substantial cash needs in the coming years. On February 24, 1969, The New York Times reported that Penn Central was planning a $100 million borrowing in the near future. (Ex. A-218) Less than two months later, The New York Times reported that Penn Central had set plans for loans amounting to $375 million. (Ex. A-212)

By the fall of 1969, indications of a cash squeeze were readily apparent. For example, the October 21st Wall Street Journal announcement of third quarter results (Ex. A-195) referred to an increase in fixed charges from $7.7 million to $32.5 million for the quarter "primarily because of financing of heavy capital programs undertaken since the merger . . . ."

A little over a month later Penn Central announced the elimination of its cash dividend for the final quarter

of 1969 in order "to conserve cash." (Ex. A-187). In making that announcement Saunders noted that Penn Central had already paid out more in dividends in 1969 than it had earned during the year. This major article bore the headline "PENN CENTRAL OMITS PAYOUT TO CONSERVE CASH."

Further public knowledge of the cash-tight situation is reflected in the announcement two weeks after the 1969 year-end losses were published that a second dividend in a row would be omitted. (Ex. A-180).

In light of this indisputably public knowledge, several somewhat more specific facts alleged to have been omitted appear in proper perspective. For example, Goldman, Sachs' blue sheet of February 5, 1970 (Ex. PX-11 (A-71)) includes the following statement by Wilson: "I asked what their cash picture looked like for the first six months of this year. He [Bevan] said it is very tight. He said they will probably need about $200MM to meet their requirements this year. He then went on to describe how they plan to obtain this money." Notwithstanding plaintiff's claim that this information should have been communicated to it, nothing appears in this statement with respect to the cash situation that The Wall Street Journal had not already announced. In contrast to the newspaper articles, however, Wilson was told exactly how the cash tightness would be solved, and this

latter information was more rather than less favorable. A verbatim description of the conversation between Wilson and O'Herron would thus have created a more optimistic picture than could have been obtained merely from reading the newspapers.*

The specific cash needs of Penn Central were also a matter of general public knowledge. Wilson's rough calculation of cash needs was based upon two components: the $170 million required for various capital costs, including capital improvements and equipment, and the $56 million anticipated operating loss in the railroad. (See Ex. PX-12 (A-69), second paragraph) The $170 million figure was public information. The Wall Street Journal of February 5, 1970 described the 1969 results and reported that Saunders had "said Penn Central expects to spend only about $170 million in capital expenditures in 1970, down from $270 million in 1969." (Ex. A-182)

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* O'Herron's request far earlier -- in September of 1969 (Ex. PX-20 (A-90)) -- that Goldman, Sachs "put out as much paper in April or longer" merely meant that Goldman, Sachs should try to sell paper maturing after the end of the first quarter -- a time when cash would be tight -- as it had been historically. (See Vogel, Tr. 520-22; Wilson, Tr. 978). This was a matter of sound financial planning and did not have even remote significance to investors -- especially those purchasing 6 months later, after the whole discussion was necessarily moot.

As previously indicated, in light of the downward trend of Penn Central's earnings, it was reasonable to calculate that the unconsolidated loss for 1970 would be $56 million at a minimum. Accordingly, the basis for Wilson's conclusion that cash needs for 1970 would be $226 million ($170 million plus $56 million) was one which could have been drawn from public information.

Even apart from the depth and breadth of publicly available information on the cash situation, O'Herron's communication to Wilson of Penn Central's expected 1970 cash needs was not material if taken in context. The statement was made as part of an explanation of cash planning for the coming year. Wilson was not only told what cash was needed, but more critically, Penn Central's plans for raising that cash.

As previously indicated, Goldman, Sachs reasonably concluded on the basis of its knowledge of Penn Central's financial condition and the condition of the money markets that this cash could in fact be raised. (See, e.g., Levy, Tr. 755-756) Even before UHF's purchase, the first step in Penn Central's program was successfully accomplished by means of the "bridge" loan obtained by Pennsylvania Company and loaned "upstream" to Penn Central. (Sullivan, FSB Tr. 868-69, 873-74) Other necessary financing steps were

in progress at the time of UHF's purchase and there was at that time no reason to believe that they would not succeed. In the context of this apparently successful program for meeting cash needs, the simple statement that such needs existed was not significant. (See Vogel, Tr. 543-45).*

iii. Working Capital Deficit

Plaintiff's argument heading suggests that a failure to disclose the working capital position of Penn Central was also a material misleading omission for which Goldman, Sachs should be held liable. No argument is made with respect to this point, however, and it appears not to be an issue seriously pressed by plaintiff. It should be noted for the record, however, that the working capital of Penn Central was reported on a quarterly basis in Moody's Transportation Manual and Standard & Poor's Corporate Records -- both of which LeMay acknowledged were available within his own department at Union Bank. (LeMay, Tr. 82-83; Exs. AM & AN).

In addition, it should be noted that plaintiff offered no proof whatsoever that working capital is a

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* In addition, it should be noted that Penn Central's banks were given somewhat more precise figures on cash flow (Ex. AA) and reached the same conclusion that despite "the expected tight cash position of the Railroad itself" it was appropriate to lend it money via its wholly owned subsidiary Pennsylvania Company. (Sullivan, FSB Tr. 864-65).

significant factor in credit analysis or that it would have affected the judgment of a reasonable investor in plaintiff's position. In the absence of any such demonstration, it is respectfully submitted that the matter should be ignored.

6. No Facts Regarding Penn Central's Use of the Proceeds From Its Sale of Commercial Paper or the ICC's Views Concerning That Matter Were Required to be Communicated To Plaintiff

Plaintiff alleges that Goldman, Sachs failed to disclose that Penn Central was not using the proceeds of its commercial paper sales for "current transactions," and that in addition it failed to reveal to plaintiff that the I.C.C had commented adversely with respect to this matter.

The concept of "current transactions" is essentially a matter of accounting treatment rather than credit analysis. For practical purposes dollars are fungible, at least in the absence of proof that funds were segregated and directly applied to a specified purpose. The notion that any particular funds were "current" is, by itself, meaningless. Indeed, as Wilson testified, the Securities and Exchange Commission has recognized that in a variety of circumstances the notion of "current transactions" is incapable of direct application and that analogous tests must be applied to determine whether or not a company is exempt from

the so-called "current transaction" provision of Section 3(a)(3) of the Securities Act of 1933. (Wilson, Tr. 843-46).*

Plaintiff argues briefly that one of the several tests applied by the S.E.C and described by Wilson -- namely the comparison of proposed commercial paper outstandings with accounts receivable -- was not met in the case of Penn Central. (Plaintiff's Post Trial Brief, at 137 n.*). Plaintiff reaches that conclusion only by persisting in its argumentative position that Penn Central Transportation Company's financial condition must be viewed as though the company had no subsidiaries. In fact, of course, the assets and earnings of the subsidiaries were very significant and must necessarily be considered in conjunction with those of the Transportation Company itself in determining creditworthiness. (Vogel, Tr. 493-95). Despite that fact, and without explanation or even disclosure of its tactic, plaintiff cites receivables for the parent company only, without regard to consolidated figures which show receivables in approximately the amount indicated by O'Herron in his conversation recorded in the Goldman, Sachs blue sheet dated September 19, 1969. (Ex. PX-20 (A-90); Ex. A-21, at 27).

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* In the case of Penn Central, the issue of exemption under Section 3(a)(3) is irrelevant because the paper was in any event exempt under Section 3(a)(6) of the 1933 Act.

Although plaintiff offers no substantial argument to support the notion that the use of proceeds for any particular purpose was material, it does offer testimony that as a matter of ordinary routine Goldman, Sachs did inquire of issuers what use was to be made of commercial paper proceeds. But not every matter of routine inquiry is a matter of material importance. Particularly where, as here, the purpose of the routine inquiry -- satisfaction of the requirement of Section 3(a)(3) in the ordinary circumstance of a non-transportation issuer -- is adequately explained.

Apart from the assertion that inquiries into the use of proceeds were routine, plaintiff has sought to rely upon the testimony of LeMay in support of its proposition that the use of proceeds was a material matter. In this particular instance, however, LeMay's self-serving statements are inadequate even if taken at face value. On cross examination, LeMay's attention was called to the current transactions issue and he testified as follows:

> Q. Could you refresh me, please. What was your testimony on the hypothetical question as to the use of proceeds of commercial paper? What did you say if you had known what the use of the proceeds was you would not have bought the paper, is that right?
>
> A. I had known?
>
> Q. Do you recall being asked about --

A. I testified that commercial paper is used for short-term investments of 270 days or less and it's for those purposes.

Long-term investment lines of credit are exercised on other types of loans, but commercial paper is used for short-term investments. Also for the current working cash of the concerns. This is why they sell commercial paper. That is the reason for it.

Q. Focusing on the second point, the use that the borrowing company makes of the money, would that use have made any difference to you in deciding whether or not to buy the paper?

A. No. I had no way of knowing what they were doing.

Q. You never asked?

A. No.

(LeMay, Tr. 94-95) (emphasis supplied).

It is thus apparent that even LeMay was unable to articulate the significance of the so-called "current transactions" test, and thus absolutely the matter was clearly not of material significance.

Plaintiff also argues that Goldman, Sachs should have disclosed the I.C.C.'s comments regarding Penn Central's continued reliance upon short-term borrowings. As has previously been noted, however, the ICC report (Ex. PX-64) -- in addition to noting the potentiality for difficulty in continued reliance upon short-term financings -- reached the

conclusion that such financings should properly continue for a period of two years beginning in November of 1969. The stated basis for that conclusion is omitted from plaintiff's memorandum but is of the utmost significance:

> "On the whole applicant is in a strong financial condition and in view of the present tight money market and applicant's stated intent to negotiate long-term financing as soon as it is feasible, we conclude that the application should be approved, subject to a condition restricting the issuance of such notes to a period not exceeding two years from the date the order herein is served."

(Ex. PX-64, at 4).

It is thus apparent that plaintiff's cryptic and unelucidating argument like all others advanced, fails -- principally for lack of any competent testimony or documentary evidence with respect to the issue of materiality.

CONCLUSION

In early 1970 Goldman, Sachs shared the view of virtually every professional who had analyzed the Penn Central system that Penn Central was creditworthy. At trial plaintiff offered no witnesses and no evidence to suggest that Goldman, Sachs' judgment was unreasonable or that the basis on which that judgment was predicated was erroneous. The evidence establishes beyond question that Goldman, Sachs' judgment was reasonably and honestly held, and that in the circumstances of the commercial paper market and

plaintiff's relationship with Goldman, Sachs, no misstatement was made and no material fact was unknown to plaintiff which rendered misleading any statement made by Goldman, Sachs.

Judgment should be entered in favor of defendant, dismissing the complaint with prejudice.

Respectfully submitted,

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APPENDIX A

ANALYSIS OF ASSETS REVIEWED AS PART OF CREDIT STUDY OF PENN CENTRAL

The credit analysis carried out by Jack Vogel involved viewing the assets owned wholly or in part by Penn Central Transportation Company or Pennsylvania Company ("Pennco"), ascertaining their worth, and then determining what portion of that worth was available to Penn Central.

On or shortly before March 13, 1970, Jack Vogel, based on his analysis, held the opinion that Penn Central was creditworthy. (Vogel, Tr. 554).* Although Vogel was certain that Penn Central had usable assets well in excess of debt, that is, a substantial "cushion," he was unable to recall at trial -- five years or more after the critical events -- the specific figures involved.

A reconstruction of his cushion study demonstrates that assets available to Penn Central in February and March -- even though they represent only a fraction of the assets in

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* Vogel's testimony on his judgment of Penn Central's assets is clear, and, more crucially, it is uncontradicted.

> "Q. Based on your valuation of these assets, the net free of debt, you felt that Penn Central was creditworthy in or about March, 1970?
>
> "A. Yes, there was no question in my mind it was credit worthy at that point."

(Vogel, Tr. 554).

the Penn Central system and even after subtracting the value of debt including commercial paper debt -- had values in excess of $600 million.

At the threshold, it is useful to review briefly the corporate structure of the Penn Central system.* Penn Central Transportation Company, the issuer of commercial paper, was the wholly-owned subsidiary of Penn Central Company, formed in the fall of 1969, as a holding company and vehicle for making future acquisitions.** (Vogel, Tr. 497-98). At all times up to and including March 13, 1970, the financial statements of these two companies were practically identical.*** Because of the almost total identity between these two corporate entities, it is reasonable to

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* For Penn Central's organizational chart, see Defendant's Trial Memorandum at 28.

** A full description of the recapitalization plan appears in Exhibit A-17, at 6.

*** Exhibit A-9 is a page from the financial statement of Penn Central Company and consolidated subsidiaries for year-end 1969 with handwritten alterations changing it to reflect the 1969 financial statistics of Penn Central Transportation Company and consolidated subsidiaries. The differences are minimal.

See also Penn Central Company's Notice of Annual Meeting, dated April 10, 1969:

> "The pro forma balance sheet of Holding Company and its consolidated subsidiaries will reflect assets and liabilities identical with those in the balance sheet of Railroad and its consolidated subsidiaries."

(Ex. A-17, at 11).

consider Penn Central Transportation Company (hereinafter "Penn Central") as representing the entire system. (Vogel, Tr. 669-70).

Penn Central was composed of three parts: railroad operations, operating subsidiaries, and Pennsylvania Company. Pennsylvania Company ("Pennco") was Penn Central's wholly-owned investment subsidiary, which owned "[m]ost of our financial interests in companies not directly related to Pennsylvania [later Penn Central] Railroad operations . . . ." (Pennsylvania Railroad Company Annual Report 1966, Ex. A-25, at 12; see generally Ex. A-12, at 7).*

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* (See also Ex. AM-3, at 215-17; A-8, at 12-14; A-21, at 9-10; A-21a, at 7-12).

For ease of reference, a list of the Exhibit Numbers of principal exhibits used in the following discussion is set out.

Designation	Exhibit
A-8	1969 Penn Central Annual Report
A-12 (PX-63)	$50 Million Pennco Offering Circular
A-17	April 10, 1969 Penn Central Notice of Annual Meeting
A-21	1968 Penn Central Annual Report
A-21a	1967 Penn Central Annual Report
A-25	1966 Pennsylvania Railroad Annual Report
AM-1	1967 Moody's Transportation Manual
AM-2	1968 Moody's Transportation Manual
AM-3	1969 Moody's Transportation Manual
AM-4	March 6, 1970 Supplement to Moody's Transportation Manual

Vogel did not attempt to ascribe a value to the entire Penn Central system, but rather focused on a dozen or so components in the system* to ascertain the discrete values of the components analyzed. Because the purpose of a cushion study is to determine the net value to Penn Central of various components in its system, Vogel eliminated from consideration assets with encumbrances so substantial that it would require considerable effort to identify the equity.** (Vogel, Tr. 496). The point was to identify assets that even though encumbered had a readily ascertainable equity.

From the outset Vogel also realized that a substantial amount of the assets in the Penn Central system were encumbered. (Ex. A-21, at 32; Ex. A-12, at 7, 37). Accordingly, after determining the aggregate value of the components, Vogel subtracted the amount of debt of Penn Central or Pennco that was secured by the stock of any of the components, as well

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* A comprehensive view of the Penn Central system appears in the Moody's Transportation Manuals for 1967, 1968 and 1969. (See Exs. AM-1, at 340-409, 637-92; AM-2, at 413-517; AM-3, at 159-262).

** For instance, Penn Central owned and owns numerous hotels and office buildings in midtown Manhattan that have so many layers of mortgages that it would require great effort to determine their equity.

as major current debt and 1970's financing needs. (Vogel, Tr. 505, 550).* The technique is not dissimilar to the situation of an individual who mortgages his home. If the market value of a house is $100,000 and the homeowner has an $80,000 mortgage of which $30,000 is outstanding, no one would deny that this homeowner has a usable asset of $70,000.

When our hypothetical homeowner discovers that he has an equity of $70,000, he then knows that he has a substantial sum to pledge or hypothecate in order to raise cash. He also knows that pledging $70,000 in assets will not raise $70,000 in cash, but that such a pledge will comfortably cover a cash need of $20,000 or $25,000. This situation is analogous to that of Penn Central. Vogel, in conducting his credit analysis, ascertained that Penn Central had assets far exceeding all debt, including commercial paper debt, and considered that $600 million was a comfortable margin of safety. If, for instance, it was necessary to borrow $100 million to cover the commercial

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* It is not necessary to include Penn Central financings secured by equipment or trackage because the assets employed as security (i.e., trackage or rolling stock) were not included in the assets analyzed by Vogel as available to Penn Central. Vogel was simply determining discrete values for specific components owned, directly or indirectly, by Penn Central.

paper not covered by bank lines, Vogel viewed this six to one ratio and reasonably concluded that a bank would extend that sum, if not more, on the basis of those assets.

By its very terms, Vogel's cushion study considered liquidity. (Vogel, Tr. 496-97). Because Vogel was analyzing whether there were sufficient assets to cover short-term commercial paper, he was working within a framework of no more than nine months. (Vogel, Tr. 574-75). Therefore, in order that the assets be of any value to cover commercial paper, they must be able to produce cash within that time. Part of the key to this liquidity was found in the usable assets were over $600 million after subtracting all debt. Vogel knew that assets as intrinsicly valuable as those within the Penn Central system could be easily pledged especially since the amount of money desired would probably be only a sixth of their value. (Vogel, Tr. 577).

Vogel's thinking was depicted more graphically at trial:

> "Q. If you had some crown jewels, including the Hope diamond, and you had to get some cash to pay your bills tomorrow, and you couldn't sell the Hope diamond, how would you raise the cash?
>
> A. Borrow against it.
>
> Q. Go to a pawnbroker?

A. Or anyone else.

THE COURT: The person that talked about the Hope diamond yesterday also talked about mortgaging assets, but I am glad to be reminded. Sometimes you can get money, too, just by waving the Hope diamond in front of other people's faces without mortgaging it.

THE WITNESS: I suspect it happened, your Honor.

MR. MANEY: Something like a million pound note?

THE COURT: Exactly."

(Vogel, Tr. 665-66).

To determine which companies in the Penn Central system should be part of a cushion study, Vogel, naturally enough, looked to the list of companies appearing in the offering circular for Pennco's $50 million debenture offering (Ex. A-12, at 7) and in the April 10, 1969 notice of annual meeting (Ex. A-17, at 15; see Vogel, Tr. 504, 551, 553).

Vogel viewed basically seven companies owned or controlled directly by Penn Central: Pittsburgh & Lake Erie Railroad ("P.&L.E."), Merchants Despatch Transportation Corporation; Penndel Company; Pittsburgh, Fort Wayne & Chicago Railway Company; American Contract Company; Clearfield Bituminous Coal Corporation; Despatch Shops, Inc.; and Manor Real Estate Company. From those companies owned or controlled by Pennco, Vogel analyzed Arvida Corporation; Euckeye Pipe

Line Company; Detroit, Toledo & Ironton Railroad Company ("D.T.&I."); and Great Southwest Corporation. He also ascertained the value of Pennco's holdings in Norfolk and Western Railway Corporation ("N.&W.") and Wabash Railway Company. Additionally, Vogel determined the value of two assets held jointly by Penn Central and Pennco: Madison Square Garden Corporation, and the Philadelphia, Baltimore & Washington Railroad Company ("P.B.&W."). (See Vogel, Tr. 550-54).

According to the cushion study, a different method of evaluating the worth of a company was used depending upon the amount and kind of financial information available. The record reveals basically three types of companies within the Penn Central system: publicly traded companies, companies not publicly traded with reported, public earnings, and companies not publicly traded and without reported, public earnings.

For a company the stock of which was publicly traded, value was determined by the market price of the stock multiplied by the number of shares owned by Penn Central or its subsidiaries. (Vogel, Tr. 499). For a company the stock of which was not publicly traded but which had reported earnings, the value of the company as a going concern was ascertained by multiplying earnings by an accepted multiple. (Vogel, Tr. 503). The figure for earnings was derived by

averaging the company's earnings for three prior years in order that the figure used in the cushion study would fairly reflect the company's earnings picture and would not be distorted by a particularly favorable or unfavorable year. The multiple chosen by Vogel was 10 which was "on the conservative side" (Vogel, Tr. 503-04), and the reasonableness of which was not questioned by plaintiff.* Once the earnings were multiplied by 10, the value obtained was then multiplied by the percentage of stock ownership held by Penn Central or Pennco. (Vogel, Tr. 503). For companies not publicly traded and the earnings of which not publicly reported, the value of the assets was determined by referring to the net value of the investment on the books of Penn Central or Pennco. (Vogel, Tr. 504). This technique also produces a conservative estimate of the company's worth.

Vogel's "cushion study" -- by using only net asset values** and by employing a conservative multiplier --

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* Exhibit A-111, memorandum from William J. Kealy dated May 13, 1969 and a part of the Penn Central Credit File available to Vogel, confirms the reasonableness of using "a multiple of only 10 times" earnings.

** For a company for which a price/earnings formula was employed, the use of earnings, as opposed to revenues, assured that the formula excluded that part of the company's revenues needed to service and ultimately retire any debt. For a company for which market trading value was used, it is justifiably assumed that the trading price of the stock reflected the market's assessment of any debt. Finally, for a company for which an estimated net asset value was employed, the reasonableness of the estimate, given the history and structure of that company, assured a fair net value.

reached a fair approximation of the value of usable assets to which Penn Central had access. Goldman, Sachs' estimate of Penn Central's usable assets exceeded $600 million -- a figure many times in excess of the amount of commercial paper outstanding.

a. Publicly Traded Companies.

Great Southwest Corporation and Arvida Corporation were two real estate companies owned by Pennco. "Arvida Corporation, in which Penn Central has a 59 per cent interest, owns and operates properties in four of Florida's fastest-growing areas -- Dade, Broward and Palm Beach counties on the East Coast and Sarasota on the West Coast." (Ex. A-21, at 10). Although it principally was engaged in the construction of condominium apartment buildings* on the approximately 35,000 acres owned in Florida (Ex. A-12, at 10), one of its major developments was the Boca Raton Hotel and Club, near Sarasota. (See Ex. A-21a, at 10-12).

Great Southwest owned and invested in real estate on a national scale. The $50 million debenture offering sets forth an abbreviated description of its holdings:

> "As of October 31, 1969, Pennco held 92% of the voting stock of Great Southwest Corporation, a real estate development company with operations in California, the Dallas-Fort Worth area of Texas, Atlanta, Georgia and St. Louis, Missouri. The

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* (Exs. A-25, at 13-14; A-21a, at 10-12; A-21, at 10; A-8, at 14).

California operations represent those of Macco Corporation, formerly a 100%-owned subsidiary of Pennco, which was merged into a wholly-owned subsidiary of Great Southwest in 1969. Great Southwest engages in residential, commercial, industrial and recreational land development as well as land investment. As of June 30, 1969, Great Southwest owned approximately 31,700 acres of land and leased, as lessee, approximately 935 acres. Joint ventures and partnerships in which Great Southwest had varying interests at that date owned approximately 10,125 acres (excluding a one-third interest, subsequently sold for $19 million in cash, in two partnerships which owned approximately 64,400 acres). Great Southwest recently sold, but continues to operate, two large family amusement parks located at Dallas-Fort Worth and Atlanta, and has commenced construction of a similar park near St. Louis. In addition, Great Southwest recently agreed to purchase a manufacturer of mobile homes which had sales of approximately $17.8 million in 1968."

(Ex. A-12, at 8-9).*

Both were traded in the over-the-counter market and Vogel multiplied the number of shares held by Pennco by the bid price of the common stock on February 6, 1970.** (Vogel, Tr. 544-45). This technique resulted in a value

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* For a more detailed account of its operations, see Exs. A-25, at 14-15; A-21a, at 10; A-21, at 9-10; A-8, at 13-14).

** Vogel obtained the then current market price of common stock held by Penn Central or Pennco from the daily quotations "[e]ither in the Wall Street Journal or The New York Times or the pink sheets or sometimes directly from the traders." (Vogel, Tr. 500). These prices can be reconstructed from either the ISL Daily Stock Price Index, New York Stock Exchange for January, February, March 1970 (Ex. DO), or the ISL Daily Stock Price Index Over the Counter for January, February, March 1970 (Ex. DN).

of $42 million for Arvida* and $380 million for Great Southwest.**

Pennco also owned the stock, subject to varying restrictions, of two railroads, the Norfolk & Western Railroad Company and the Wabash Railroad Company. The N.&W., "one of the major rail systems serving the East and Midwest," (Ex. A-12, at 19), operated 7,585 miles of track (id. at 22) in sixteen states and two Canadian provinces.*** It was primarily a freight hauler, deriving in 1968, 99 per cent of its net railway operating income from freight service. (Id.). The Wabash, operated under lease by N.&W., was part of that system. (Ex. AM-3, at 867-69).****

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* Pennco's $50 million offering circular reveals that it owned 3,529,277 shares of Arvida common stock (A-12, at 7), or 59%. (Id. at 10). Compare (AM-3, at 216). These shares at the bid price of February 6, 1970 of 12 1/8 (Ex. DN, at 22) produces a net value of $42,792,435.

** Pennco owned 22,347,240 shares of Great Southwest common stock (Ex. A-12, at 7), over 90% of the amount outstanding. (Id. at 8). Compare (Ex. AM-3, at 216). At February 6's bid price of 17 (Ex. DN, at 119), these shares were worth $379,903,080.

*** A map of the N.&W. system appears at AM-3, at 840.

**** "The main line of the [Wabash Railroad] company extends from Buffalo, N.Y. (via trackage rights over Canadian National Railways from Buffalo, N.Y., to Windsor, Ont., opposite Detroit, Mich.) to Kansas City, Mo., Omaha, Neb. and Des Moines, Ia. The system is about 2,245 miles long and serves Chicago, Ill., St. Louis, Mo., Detroit, Mich., Toledo, Ohio, Omaha, Neb., Des Moines, Ia., and South Bend, Ind."

(Ex. AM-3, at 866).

Pennco's ownership of both the N.&W. and Wabash stock was somewhat complicated as a result of orders of the I.C.C. approving the corporate restructuring of the Wabash and N.&W. with the end result that Pennco was required to divest itself of N.&W. stock. (See Exs. AM-3, at 216, 839-42, 866-67; A-12, at 10-12, 17-30).

Of the 1,613,705 shares of N.&W. common stock held by Pennco on October 31, 1969, 516,228 were in escrow to provide for exchange of Pennco cumulative preferred stock into N&W common. (Exs. A-12, at 11; AM-3, at 217). The total value of the remaining 1,097,477 shares, at $78-3/8, February 6's closing price on the New York Stock Exchange,* was $86,014,579.**

Pennco owned 595,255 shares of Wabash common and 101,836 of Wabash preferred. (Ex. A-12, at 7). The Wabash

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* (Ex. DN, at 244).

** Under an exchange agreement with N.&W., approved by the I.C.C., Pennco was to exchange 800,000 shares in ten equal installments beginning October 1966 for $104 million principal amount N.&W. debentures. (Ex. A-12, at 11).

Of the total N.&W. shares held by Pennco, 400,000, as of October 10, 1969, carried with them exchange rights for N.&W. debentures. (Ex. A-12, at 7). These 400,000 shares, while carrying a market value of $31,350,000 on February 6, 1970, were convertible into $52 million of N.&W. debentures. (See generally Ex. AM-3, at 216-17).

common, valued at February 6's closing price,* resulted in a value of $36,310,555. Because Pennco had agreed with N.&W. to exchange this Wabash common for 671,692 shares of N.&W. common on October 15 (id. at 11), the stock was effectively worth $52.6 million.** (See also Ex. AM-3, at 216). It was this latter figure which Vogel used. (Vogel, Tr. 551). (See also Ex. A-12, at 7). The preferred stock was valued at $6 million in the Pennco $50 million offering circular.***

Finally, Vogel valued the shares of Madison Square Garden Corporation held by both Penn Central and Pennco at the February 6, 1970 closing price of 5-3/8. (Vogel, Tr. 553).**** The usable asset value of Madison Square Garden in the Penn Central system was accordingly $12 million.*****

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* (Ex. DN, at 356).

** 671,692 shares of N.&W. common stock at 78-3/8 produced a value of $52,643,860. (Ex. DN, at 244).

*** (Ex. A-12, at 7). The circular used December 10, 1969's bid price for the preferred stock in the over the counter market.

**** (Ex. DO, at 211.)

***** On December 31, 1968, Penn Central acquired 1,168,664 shares of the common stock and 100,000 shares of the participating preferred of Madison Square Garden Corporation. Shortly thereafter, the preferred shares upon approval of the stockholders was converted into 1,151,000 additional shares of common. (Ex. A-17, at 16; Ex. AM-3, at 163). In July 1969, Pennco purchased from its parent 1,462,109 shares of the common stock (Ex. A-12, at 13), leaving Penn Central with 857,555 shares.

At February 6's closing price of 5 3/8, the usable asset value of the shares held by the parent was $4,609,358 and by Pennco was $7,858,835, for a total of $12,468,193.

b. Companies with Reported Earnings

The P.&L.E., approximately 93% owned by Penn Central (Ex. A-17, at 15), "was a very profitable railroad" (Vogel, Tr. 551) operating in Western Pennsylvania and Ohio. (Ex. AM-3, at 229). It derived a large portion of its revenues from serving the needs of that area's iron and steel manufacturers. (See Ex. A-21, at 23; cf. Ex. A-8, at 12)* Utilizing Vogel's price/earnings formula produces a value for the P.&L.E. of $116 million.**

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* In 1968, P.&L.E. hauled a total of 26,048,864 tons, of which 16,915,150 or 65%, consisted of metallic ores, coal, and limestone, materials necessary for the production of steel. (Ex. AM-3, at 220 ("Freight Traffic").

** Vogel's formula applied to the three-year period ending 1969 produces the following:

	Net Operating Income	Sources
1967	$12,761,473	(AM-3, at 231)
1968	13,691,003	(AM-3, at 231) (AM-4)
1969	11,253,387	(AM-4, at 1774)
	37,705,863	

$$\frac{37,705,863}{3} = \$\ 12,568,621 \quad \text{(average)}$$

$$12,568,621 \times 10 = 125,686,210 \quad \text{(multiple)}$$

$$125,686,210 \times .9261 = 116,397,999 \quad \text{(\% of ownership) (Ex. A-17, at 15)}$$

In reaching an assessment of the value of the P.&L.E., Vogel had available as of March 6, 1970, the net railway operating income for 1969. (Ex. AM-4, at 1774)

Merchants Despatch Transportation Company owned and leased refrigerator cars which it furnished to railroads along with ancillary services. (Ex. AM-3, at 209). It was 100% owned by Penn Central. (Id. at 210). Using a price/earnings formula for Merchants Despatch results in an asset value of $18 million.*

Buckeye Pipe Line Company, operated as a wholly-owned subsidiary of Pennco (Ex. AM-3 at 216, 218) was, as of December 16, 1969, the nation's twelfth-largest pipeline system in terms of total operating revenue and seventh-largest in terms of barrels of crude oil. (Ex. A-12, at 12; Ex. A-17,

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* Vogel did not have available the 1969 year-end results of Merchants Despatch Company when he conducted his February-March cushion study. He therefore used results for 1966 through 1968 as follows:

	Net Income	Sources
1966	$2,379,800	(AM-2, at 465)
1967	1,844,340	(AM-3, at 209) (AM-2, at 465)
1968	1,409,674	(AM-3, at 209)
	5,633,814	

$\frac{5,633,814}{3}$ = $ 1,877,938 (average)

x 10 (multiple)

18,779,380

If year-end 1969 results had been available to Vogel, his calculations would have produced a higher value for Merchants Despatch because earnings for 1969 were greater than those for 1966.

at 15). Pennco also owned practically 100 per cent* of the outstanding shares of the Detroit, Toledo & Ironton Railroad Company ("D.T.&I.") (Id. at 12), which operated approximately 475 miles of track in the highly industrialized territory from Detroit through Toledo to Ironton, Ohio. (Ex. AM-3, at 239). After Flat Rock yard, its terminal facility for the Greater Detroit area, was renovated, the D.T.&I. became increasingly profitable (Ex. A-21, at 23).** Both these companies also were not publicly traded but had published earnings. The appropriate investment banking technique produced a value of $132 million for Buckeye***

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* According to the April 10, 1969 Notice of Annual Meeting, Penn Central owned 99.99%. (Ex. A-17, at 15). In fact, of the 245,333 outstanding shares of D.T.&I., all but four were held by Pennco. (Ex. AM-3, at 243).

** (Compare Ex. A-25, at 13, with Ex. A-8, at 12).

*** For Buckeye, Vogel used earnings for the three years ending 1968.

	Net Income	Sources
1966	$12,425,130	(AM-2, at 472)
1967	13,604,000	(AM-3, at 218)
		(AM-2, at 472)
1968	13,811,000	(AM-3, at 218)
	39,840,130	

$\frac{39,840,130}{3}$ = $ 13,280,043 (average)

x 10 (multiple)

132,800,430

Shortly after March 16, 1970, Vogel had available for use in conducting his study Penn Central's 1969 Annual Report, which reported Buckeye's net income as $12,221,000 in 1969. (Ex. A-8, at 12). If 1967-69 figures are used, the amount of usable assets in Buckeye does not substantially change.

and $24.6 million for the D.T.&I.*

c. Companies with Estimated Values

Penndel Company, incorporated in 1953, owned 1,369 miles of tract in over 60 separate locations. (Ex. AM-3, at 215). It was operated under a lease by Penn Central which was terminable on 60-days notice and provided for the elimination of separate accounting. (Id.). The Pittsburgh, Fort Wayne & Chicago Railway ("Fort Wayne") owned over 460 miles of track from Pittsburgh to Chicago. (Id. at 215, 228-29). Neither had any debt. (Id. at 215, 228-29).

From his experience, Vogel estimated that the Penndel Company, with total assets as of December 31, 1968

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* Vogel's formula for the D.T.&I. shows:

	Net Income	Sources
1966	$3,489,394	(AM-3, at 241) (A-12, at 12)
1967	998,161	(AM-3, at 241) (A-12, at 12)
1968	2,905,403	(AM-3, at 241) (A-12, at 12)
	7,392,958	

$\frac{7,392,958}{3}$ = $ 2,464,319 (average)

x 10 (multiple)

24,643,190

The 1969 Annual Report for Penn Central, dated March 16, 1970, gave the 1969 year-end results for the D.T.&I. as $4,200,000 (Ex. A-8, at 12), reflecting an increased value for that company.

of $125 million,* and the Fort Wayne with total assets as of December 31, 1968 of almost $148 million,** each had a usable value of $50 million. (Vogel, Tr. 553-54). This estimate was based on his assessment of the amount of potential loans that these companies, neither of which had at that time any pledged stock, could obtain. (Id.).

American Contract Company, an investment company, Despatch Shops, Inc., engaged in car-building and real estate, Clearfield Bituminous Coal Corporation, owner and developer of coal lands, and Manor Real Estate Company, a land company, were 100% owned by Penn Central (Ex. AM-3, at 161). Because these companies had no reported income and were not publicly traded (Vogel, Tr. 504), Vogel accepted the December 31, 1968 net asset value indicated in the Penn Central Company proxy statement dated April 10, 1969. (Ex. A-17) (Vogel, Tr. 504, 553). The values obtained by Vogel from that proxy statement were $15 million for American Contract, $17 million for Despatch Shops, $16 million for Clearfield and $26 million

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* (Ex. AM-3, at 215). Penn Central owned 100% of the outstanding capital stock of Penndel and operated it under a lease.

** Id. at 228. Penn Central owned approximately 24% of the outstanding preferred stock and over 90% of the common stock, and operated this road under a 999-year lease granted in 1869.

for Manor. (Ex. A-17, at 15).*

The Philadelphia, Baltimore & Washington Railroad Company owned about 2,330 miles of track, in part from Philadelphia to Washington, and in part (as a result of an earlier merger) from Pittsburgh to St. Louis (Ex. AM-3, at 224), and Penn Central operated it under a lease. (Id.). Vogel took from Pennco's $50 million offering circular (Ex. A-12, at 7) the value of this company as $34 million. (Vogel, Tr. 551).

d. Other Assets

In carrying out his cushion study, Vogel arrived at a value for the real estate of Penn Central that was not pledged (Vogel, Tr.) "of something in excess of a hundred

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* The Notice of Annual Meeting and Election of the Penn Central Company, dated April 10, 1969, discloses the exact net asset value, as of December 31, 1968, of the following companies:

American Contract Co.	$15,648,823
Clearfield Bituminous Coal Co	16,316,414
Despatch Shops, Inc.	17,564,711
Manor Real Estate Co.	26,658,792

(Ex. A-17, at 15).

million dollars . . . ." (Id. 552-53).* Penn Central's accounts receivable "ranged up to something like $300 million alone . . . ." (Id. 552).**

Finally, the audited financials of Pennco's $50 million offering circular also showed $16 million in cash for Pennco as of June 30, 1969 (Ex. A-12, at 35), which was a usable asset. (Vogel, Tr. 498-99, 549).

The total value of the components reviewed by Vogel was $1492 million, including $772 million of assets controlled by Pennco.

Vogel then subtracted all "debt" that was a charge against these particular assets. (Vogel, Tr. 505, 550). He counted as a charge against the usable assets all debt of Penn Central and Pennco secured by the stock of subsidiaries to the extent that debt was outstanding. Included in the secured debt was $250 million outstanding on Penn Central's revolving credit agreement, $39 million outstanding on three

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* A description of Penn Central's considerable real estate operations in Chicago, Philadelphia, Pittsburgh, and Washington, D.C. is found in Penn Central's 1968 Annual Report. (Ex. A-21, at 8-9). (See also Exs. A-25, at 15; A-21a, at 9-10; A-8, at 13; AM-3, at 163).

** Penn Central had accounts receivable of $261,665,000 as of December 31, 1968 (Ex. A-21, at 27), and of $322,584,000 as of December 31, 1969 (Ex. A-8, at 17).

Penn Central collateral trust obligations,* and $130 million outstanding of Pennco debt.** As a charge against usable assets, Vogel considered current unsecured debt, which was composed of Penn Central's Eurodollar revolving credit agreement ($50 million), Penn Central's commercial paper ($200 million), and Pennco's Bridge Loan ($50 million), for a total of $300 million. Having read the February 6 blue sheet, Vogel knew Penn Central's cash needs for 1970:

> "The railroad needs an additional $170MM for 1970. Adding in the $56MM anticipated loss, their requirements this year are $226MM. The $170MM requirement is made up of $100MM of capital improvements and $70MM for equipment. The $70MM for equipment has either been arranged for or will be under equipment trust certificates. This leaves $150MM to be financed."

(Ex. PX-12 (A-69)) (See also Vogel, Tr. 544-45).*** Actually,

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* (See Ex. AM-3, at 192-93 (Item 19 ($8,599,900 outstanding as of December 31, 1968)), at 193 (Item 22 ($21,159,000 outstanding as of December 31, 1968)), and at 194 (Item 28 ($8,293,800 outstanding as of December 31, 1968))).

** Pennco's outstanding secured debt included $14,300,000 in collateral trust 4s to 4-1/2s (as of December 31, 1968) (Ex. AM-3, at 217); $30,350,000 in collateral trust 5-1/4s (as of December 31, 1968) (id); $35,000,000 in collateral trusts 8-1/4s (as of July 31, 1969) (id.; Ex. A-212 (article from April 17, 1969 The New York Times)); and $50 million of sinking fund debenture 9s (as of December 31, 1969) (Ex. A-12). The precise total was $129,650,000.

*** Equipment trust debt need not be counted because it is not a charge on the usable assets considered by Vogel. It is a charge on particular rolling stock and in the case of 1970 $70 million needs, a charge on assets not yet purchased.

$156 million had to be financed. Adding the $156 million of 1970 financing needs* to the secured debt and curent debt produces a charge against the assets analyzed by Vogel of $875 million.

This charge of $875 million subtracted from the usable assets of $1492 million provided Penn Central with a $642 million "cushion."

The following table is a summary of the preceding analysis of Penn Central's usable assets:

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* The $50 million Bridge Loan was a part of 1970 financing needs and in effect is counted against Penn Central's usable assets twice.

Components		Usable Assets (millions)
Penn Central		
American Contract		15
Clearfield Coal		16
Despatch Shops		17
Fort Wayne		50
Madison Square Garden		12
Manor		26
Merchants Despatch		18
Pennco		
Arvida	42	
Buckeye	132	
D.T.&I.	24	
Great Southwest	380	
N.&W.	86	
P.B.&W.	34	
Wabash	58	
Cash	16	
	772	772
Penndel		50
P.&L.E.		116
Real Estate Holdings		100
Accounts Receivable		300
Total		1492

Decription of "Debt"		"Debt" (millions)	
Penn Central			
Domestic Revolving Credit	250		
Commercial Paper	200		
Eurodollar Revolving Credit	50		
Collateral Trusts	39		
Total Penn Central	539	539	
Pennco			
Secured Debt	130		
Bridge Loan	50		
Total Pennco	180	180	
1970 Cash Need		156	
Total "Debt"		875	875
"Cushion"			617
Total "Debt" and "Cushion"			1492

In conclusion, Jack Vogel analyzed certain assets in the Penn Central system and concluded that the aggregate figure reached was substantially in excess of all debt in Penn Central and Pennco and what he thought were their upcoming financing requirements. The preceding reconstruction of the net value of assets in the Penn Central system from information available and used by Vogel in February and March 1970, confirms his judgment then that there were usable assets substantially -- that is, $617 million -- in excess of all debt and financing requirements. Further, the sizable "cushion" as of February and March 1970, demonstrates a reasonable basis for Vogel's judgment that Penn Central was creditworthy.

APPENDIX B

SUMMARY OF DEPOSITION TESTIMONY

David C. Bevan, Chairman of the Finance Committee and Director of Penn Central, was the chief financial officer of the Penn Central system. Mr. Bevan's testimony on deposition is the best evidence of the internal Penn Central data would have been furnished to Goldman, Sachs had it been requested. Bevan testified that Penn Central would never have given to outsiders -- which definition included Goldman, Sachs -- the internal working projections used by management which changed from day to day. Bevan did establish through his testimony that the documentation, such as official budgets, which might have been furnished to Goldman, Sachs had it been requested would have substantiated the figures furnished orally by him to Messrs. Levy and Wilson. This was demonstrated by the written projection prepared for Bevan and furnished by him to Penn Central's lending banks (Ex. AA), which data was almost identical to that furnished to Goldman, Sachs on February 6, 1970. (Ex. PX-12 (A-69)).

John E. Corrigan was in 1969 and 1970 the head of Division G of The First National Bank of Chicago ("First Chicago") which made him responsible for loans to transportation and utility companies, including Penn Central. (Dep. 3-6). His testimony is offered primarily to show the reasonableness of Goldman, Sachs' judgment that at all material times Penn Central was creditworthy, but is additionally probative of certain other specific points.

On June 21, 1970, First Chicago had outstanding to Penn Central loans of approximately $28 million, which included a $15 million participation in the $300 million revolving credit (Ex. B-19), a $5 million unsecured loan on a line of credit, and an $8 million participation in the $50 million Eurodollar revolver. (Dep. 5-6; Ex. BY).

In early 1970, First Chicago, aware that earnings of Penn Central were declining during the period of 1969 and early 1970, still retained its conviction that Penn Central was creditworthy. (Dep. 15-16). Specifically, Corrigan, after learning of Penn Central's first quarter 1970 losses, continued to conclude that Penn Central was creditworthy. (Dep. 23).

In reaching a judgment of creditworthiness, First Chicago did not consider earnings projections to be relevant, but was satisfied with an historical record of the borrower's

earnings, which it deemed sufficient to form a basis for a judgment of creditworthiness. (Dep. 22-23).

In reaching a judgment of creditworthiness, First Chicago divided responsibilities between employees who were charged with collecting and analyzing routine statistical material and employees who were charged with making the ultimate judgment. Contacts between the bank and the borrowers were made only by those charged with ultimate responsibility. (Dep. 7).

Raymond C. Lepley, the present Treasurer of Penn Central, came to Penn Central in November of 1969 and was thereafter responsible for the day-to-day administration of Penn Central's commercial paper operation. (Dep. 3-4).

Beginning in the fall of 1969 Goldman, Sachs conveyed to Penn Central on several occasions, its displeasure with regard to the size of the inventory of commercial paper it was being required to carry. (Dep. 5-7). At a meeting in December of 1969, Van Cleave and others from Goldman, Sachs made clear to Lepley that the reason for Goldman, Sachs' dissatisfaction was the high cost of carrying inventory. (Dep. 7-9). Lepley's testimony thus confirms Goldman, Sachs' position that its concern with the size of inventory was unrelated to subsequent financial news regarding the Railroad.

Lepley's testimony further confirms that a repurchase of commercial paper by Penn Central from Goldman, Sachs' inventory occurred on December 23, 1969 which was directly analogous to the February inventory reduction and accordingly shows that the latter, like the former, was unrelated to credit considerations. (Dep. 17-19).

Lepley further testified that no one at Goldman, Sachs had ever expressed the view or had said anything which led Lepley to believe that any repurchase from inventory was made for credit reasons. (Dep. 25).

Lepley's testimony also confirms that the cost of obtaining additional lines was a substantial factor in Penn Central's attitude toward Goldman, Sachs' request that such lines be obtained. (Dep. 27).

Lepley participated in an investigation of the question of whether Eurodollar backup lines might be obtained for Penn Central. Lepley reached the conclusion that such lines could probably be arranged (Dep. 29-30), thus demonstrating one more source of access to credit by Penn Central.

Lepley's testimony shows that Exhibit BI was a business record maintained on a daily basis reflecting contemporaneous notes of conversations with Goldman, Sachs. (Dep. 34-36).

The daily sheet from Exhibit BI dated April 30, 1970 demonstrates Goldman, Sachs' willingness to inventory Penn Central commercial paper as late as that date. (Dep. 38-39).

John J. Sullivan is now a senior vice president of Manufacturers Hanover Trust Company (FSB Tr. 838), and in 1969 and 1970 was a vice president with responsibility for loans to large industrial companies in the eastern United States, including Penn Central. (FSB Tr. 838-40). His testimony is offered to show not only the reasonableness of Goldman, Sachs' credit investigation but also the reasonableness of its judgment that at all material times Penn Central was creditworthy.

On June 21, 1970, MHT had loans of approximately $45 million outstanding to Penn Central. (FSB Tr. 845; Ex. BY). These loans were extended in 1969 and in the first quarter of 1970 by MHT only after it had reached the conclusion that Penn Central was creditworthy. Although MHT's decision of Penn Central's creditworthiness in March 1969 (FSB Tr. 849-60) and in December 1969 (FSB Tr. 860-61) should not be underemphasized, it was really its decision in February 1970 to participate in the bridge loan that is most relevant. (FSB Tr. 864).

MHT's decision to participate in the February 1970 bridge loan and to put at risk $10 million of its own money with an unsecured loan to Penn Central can only mean that, despite its knowledge of Penn Central's tight cash position and other financial difficulties, it deemed Penn Central to be creditworthy. (FSB Tr. 864-74). In fact, officials of

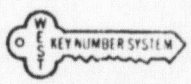
Penn Central met with representatives of MHT and other banks on February 5, 1970 and at that time reviewed essentially the same information with them that these officials did with Goldman, Sachs the following day. (Compare Ex. AD, with Ex. PX-12 (A-69)). Based on that information MHT concluded that any financial problems in the Railroad could be overcome by the reasonable and feasible plans proposed by its management that day. As Sullivan testified, "We expected that the Pennsylvania Company would be able to sell its [debentures] and that the bridge loan . . . would be repaid from the proceeds of that successful sale." (FSB Tr. 868-69; see also id. 871).

Sullivan's testimony also confirms that of Goldman, Sachs' witnesses on various other points. MHT, like Goldman, Sachs, in conducting its credit investigation deemed essential an opinion that the management of a company were persons of integrity and competence. (FSB Tr. 844-45, 874-76). MHT, like Goldman, Sachs, in conducting its credit investigation looked to the Railroad and its subsidiaries on a consolidated basis. (FSB Tr. 873-74). MHT, like Goldman, Sachs, in conducting its credit investigation looked to the underlying assets of Penn Central as a source of funds, through sale or otherwise, from which its loans could be repaid. (FSB Tr. 857). MHT, like Goldman, Sachs, in conducting its credit

investigation thought it unnecessary to require supporting documents for the assertions made by a management it trusted and whom it knew to be able and competent. (FSB Tr. 866-67). MHT, like Goldman, Sachs, in conducting its credit investigation relied on various statistical manuals including Moody's Transportation Manual. (FSB Tr. 845, 854). MHT, like Goldman, Sachs, in conducting its credit investigation was aware of Penn Central's tight cash position for 1970 and still deemed Penn Central creditworthy. (FSB Tr. 865). MHT, like Goldman, Sachs, in conducting its credit investigation did not consider lines of credit to have credit significance but recognized them as no more than a commitment to extend funds in the future if the lender continued to be satisfied with the borrower's creditworthiness. (FSB Tr. 876).

In short, the procedures of MHT with respect to its loans to Penn Central are analogous to Goldman, Sachs' procedures with respect to its being a dealer in commercial paper. Further, because Goldman, Sachs' credit investigation involved a determination whether an issuer had access to credit, Sullivan's testimony shows not only Goldman, Sachs' judgment of creditworthiness was reasonable, but also that it was correct.

F. OPINION OF HONORABLE MORRIS E. LASKER, 422 F. SUPP. 879 (S.D.N.Y. 1976)



UNIVERSITY HILL FOUNDATION,
Plaintiff,

v.

GOLDMAN, SACHS & CO., Defendant.

No. 71 Civ. 1166.

United States District Court,
S. D. New York.

Oct. 27, 1976.

Purchaser of commercial paper issued by corporation which subsequently went

bankrupt brought action against the exclusive dealer of the securities under various provisions of the securities laws. The District Court, Lasker, J., held that evidence indicated that, on the date of the purchase in question, there were sufficient warnings as to the issuer's insecure financial condition to render the broker-dealer's normal procedures relating to its ongoing credit investigation inadequate and require more concrete verification of management representations and projections, and to render its representation to the purchaser concerning the issuer's "creditworthiness" unreasonable within the meaning of section 12(2) of the Securities Act of 1933.

Judgment for plaintiff.

1. Securities Regulation ⇐143

In order for purchaser of commercial paper to recover under section 12(2) of Securities Act relating to civil liability of any person who offers or sells a security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statement not misleading, purchaser need prove neither scienter nor reliance, but some causal relationship between challenged communication and sale must be shown. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

2. Securities Regulation ⇐145

In action brought by purchaser against seller of commercial paper under section 12(2) of Securities Act relating to civil liability of any person who offers or sells a security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state material fact necessary in order to make the statement not misleading, evidence indicated that defendant broker-dealer impliedly represented that, in its opinion, issuing corporation was creditworthy, that there was reasonable basis for such opinion in that reasonable credit investigation had been conducted, and that paper involved was rated "prime." Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

3. Securities Regulation ⇐145

In purchaser's action to rescind commercial paper transaction on grounds that broker-dealer of paper in question impliedly misrepresented that issuer, which subsequently became bankrupt, was creditworthy, evidence supported finding that broker-dealer's resale to issuer of unsold issues held in broker's inventory was not result of broker's attempt to lighten its exposure in event of disaster, but rather was result of honest business considerations and that broker-dealer could in good faith believe that issuer was creditworthy at time of sale to purchaser. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

4. Securities Regulation ⇐103

In considering claim of purchaser that failure of broker-dealer of commercial paper to disclose certain discrete facts, e. g., unsuccessful efforts to convince issuer to increase bank lines, removal of notes from approved list of banking institution, and facts relating to resale by broker-dealer to issuer of unsold notes held in broker's inventory, rendered broker-dealer's implied representation that issuer was, in its opinion, creditworthy misleading or untrue one must view it in context of special circumstances of transaction, which relate both to nature of commercial paper market as whole and to modus operandi of purchaser's agent within that market. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

5. Securities Regulation ⇐103

Failure of broker-dealer to disclose to purchaser of commercial paper certain discrete facts regarding broker's unsuccessful efforts to convince issuer to increase bank lines, removal of notes in question from approved list of banking institution, and facts relating to broker-dealer's resale to issuer of unsold issues held in its inventory, did not constitute "material omissions" which rendered misleading or untrue broker-dealer's implied representation to purchaser that issuer was, in its opinion, creditworthy where such nondisclosures were motivated by legitimate business considera-

tions and not by loss of faith in paper. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

See publication Words and Phrases for other judicial constructions and definitions.

6. Securities Regulation ⇐145

Evidence, in purchaser's action against broker-dealer of commercial paper under section 12(2) of Securities Act of 1933, relating to civil liability of any person who offers or sells any security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statement not misleading, failed to support purchaser's claim that independent banking institution's "prime" rating of paper in question was based exclusively on broker-dealer's statement that it would continue to sell such paper or that broker-dealer had reason to believe that such was case. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

7. Brokers ⇐4

Under "shingle theory" when broker-dealer hangs out his shingle he implicitly represents that he will deal fairly with public.

8. Securities Regulation ⇐27

Under "shingle theory," broker-dealers are required to have reasonable basis for recommendations made to customers which, in turn, imposes obligation to conduct reasonable investigation of security's issuer.

9. Securities Regulation ⇐27

Under "shingle theory," amount and nature of investigation broker-dealer is required to have made in order to provide reasonable basis for recommendations made to customers is flexible, depending on nature and strength of recommendation and role of broker-dealer in transaction, his knowledge of and relation to issuer, and size and stability of issuing company; there are no ironclad rules as to what broker must do to meet his responsibility.

10. Securities Regulation ⇐23

Since underwriter's relation to issuer is more substantial than that of broker-dealer and it plays more central role in marketing process, somewhat more is required of underwriter than of broker-dealer to discharge its obligation to investing public to inquire into statements made in registration materials. Securities Act of 1933, §§ 5, 11(b), 12(2), 15 U.S.C.A. §§ 77e, 77k(b), 77*l*(2).

11. Securities Regulation ⇐103

Section 12(2) of Securities Act of 1933, relating to civil liability of any person who offers or sells any security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary to make statement not misleading, should apply to sale which was effectuated by means of oral communications between broker-dealer and agent of purchaser, which communications embodied implicit representations alleged to be false. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

12. Securities Regulation ⇐103

In determining whether broker-dealer properly discharged its duty of "reasonable investigation" in connection with implicit representation of "creditworthiness" of issuing company made to agent of purchaser in oral communication, it would be improper to establish inflexible rule that investigation which fails to include firsthand verification of issuer's financial condition is per se unreasonable; rather, what is required is close consideration of facts of relationship between issuer and broker-dealer, broker-dealer's access to information, nature of data it relied upon and presence or absence of "warning signals" to broker-dealer that something more might be in order. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

13. Securities Regulation ⇐23

Broker-dealer which bought virtually all commercial paper issued by issuing company, distributed it to investors, and took unsold portions into its inventory, functioned as "underwriter," both as that term is defined in Securities Act and as commonly understood in American financial com-

munity, and such dealer's implicit warrant of soundness of its basis for recommending such notes was correspondingly greater than that of ordinary broker-dealer. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2); Securities Exchange Act of 1934, § 14(e), 15 U.S.C.A. § 78n(e).

See publication Words and Phrases for other judicial constructions and definitions.

14. Securities Regulation ⇐145

Broker-dealer's credit investigation of issuing company for which it sold commercial paper was not unreasonable because it was based simply upon publicly available information and unverified representations of management or because analysis of issuing company's financial resources was conducted largely inside head of manager of broker-dealer's credit department, where there was no evidence to suggest that such informal procedures in conjunction with regular contacts with management could under no circumstances suffice to keep dealer adequately informed of issuer's strength and where credit manager's sense of issuer's credit cushion appeared to have been generally accurate. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

15. Securities Regulation ⇐103

It would be unreasonable to require commercial paper dealers to conduct far-reaching, firsthand verification of all issuing companies, no matter how strong indications of financial well-being, and thereby to provide all disappointed purchasers with cause of action against dealer for failure to do so. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

16. Securities Regulation ⇐145

Evidence, in purchaser's action against broker-dealer of commercial paper under section 12(2) of Securities Act of 1933, relating to civil liability of any person who offers or sells any security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary to make statement not misleading, indicated that on date of transaction in question there were sufficient warnings as to issuing company's insecure condition to render broker-dealer's exclusive reliance on publicly available data and unverified representations of management inadequate to meet its obligation to investing public and render broker-dealer's ongoing credit investigation unreasonable and its representation of issuer's "creditworthiness" to purchaser untrue within meaning of applicable provision of Securities Act. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

17. Securities Regulation ⇐145

In purchaser's action against broker-dealer of commercial paper, alleging violations of Securities Act of 1933, materiality of false representation that reasonable credit investigation of issuer had been conducted, i. e., that reasonable commercial paper investor would attach importance to such representation in making his investment decision, or that there was "substantial likelihood" that such was the case, was apparent from reliance placed by many investors on identity of dealer of particular issue. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

18. Securities Regulation ⇐156

Purchaser was entitled to rescind purchase and recover consideration paid for commercial paper plus interest where broker-dealer of paper made materially false representation that reasonable credit investigation of issuer had been conducted, where purchaser did not know of untruth, where untruth was causally related to sale, and where broker-dealer failed to sustain burden of proof that it could not reasonably have known of falsity of its representation. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

19. Securities Regulation ⇐121

Finding that broker-dealer, who was held to have violated section 12(2) of Securities Act of 1933, relating to civil liability of any person who offers or sells any security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the state-

ment not misleading, had acted at all times in good faith foreclosed recovery under section 10(b) or rule 10b–5. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2); Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

Regan, Goldfarb, Heller, Wetzler & Quinn, New York City, for plaintiff; Howard Breindel, Jan D. Atlas, Robert Aronson, New York City, of counsel.

Sullivan & Cromwell, New York City, for defendant; Michael M. Maney, Philip L. Graham, Jr., Charles E. Dorkey III, New York City, of counsel.

LASKER, District Judge.

This suit raises important questions regarding the application of federal securities laws to the sale of commercial paper. It is one of a number of actions by persons who in the Spring of 1970 bought commercial paper issued by the Penn Central Transportation Company (Penn Central, or the Company) from the defendant, Goldman, Sachs & Co., which was the exclusive dealer in the securities.[1]

The plaintiff, University Hill Foundation (University Hill or the Foundation), purchased two notes in the aggregate face amount of $600,000. which were to mature on September 25, 1970. At maturity the notes were duly presented, but payment was refused for, as is well known, on June 21st the Company had filed a petition in bankruptcy. The Foundation alleges that in the sale of the paper Goldman, Sachs violated § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2), § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b–5 promulgated thereunder, and a variety of state statutes and the common law.[2] It is claimed that Goldman, Sachs falsely represented both that Penn Central was creditworthy and that Goldman, Sachs had performed an adequate credit investigation, and, further, that Goldman, Sachs omitted to disclose at least six items of information necessary to render the statements made not misleading. Specifically, Goldman, Sachs is charged with failing to disclose:

1) That one month before the sale, upon receipt of a negative financial report from Penn Central, the defendant reduced its inventory of this paper by $10,000,000. by selling it back to the Company;

2) That the "Prime" rating of Penn Central paper by the National Credit Office (NCO) was not based upon NCO's independent evaluation of the paper but upon Goldman, Sachs' decision to continue selling it;

3) That for seven months prior to the sale Goldman, Sachs had unsuccessfully attempted to get Penn Central to increase its bank line coverage for its commercial paper from 50% to 100%;

4) That prior to the sale a major banking institution had removed Penn Central from its list of approved issuers;

5) That Penn Central was in a very tight cash position, lacked working capital and was experiencing increasing losses; and

6) That Penn Central was using the proceeds from the sale of commercial paper to finance non-current transactions.

Finally, the Foundation asserts that in order to prevent the collapse of the commercial paper market, Goldman, Sachs engaged in a fraudulent scheme or course of conduct to withhold negative information about Penn Central until the Company should become financially sound. The Foundation seeks to rescind the sale.

1. See *In re Penn Central Securities Litigation*, 325 F.Supp. 309 (Judicial Panel on Multidistrict Litigation, 1971).

2. The Foundation asserts claims under §§ 25401 and 25402 of the California Corporate Securities Law, West's Ann.Corp.Code §§ 25401 and 25402 (1976 Supp.), New York General Business Law § 352–c (McKinney 1968) and alleges common law fraud and negligence as well. (Exhibit D, Pretrial Order) The 1st, 3rd and 10th claims for relief asserted in the complaint allege violations of additional sections of federal and state laws; they are not included in the Pretrial Order and have not been briefed. Accordingly, we consider those claims to be abandoned and they are dismissed.

Goldman, Sachs vigorously denies the allegations. According to it, the only representation it made was that at the time of the sale to the Foundation Goldman, Sachs reasonably believed Penn Central to be creditworthy, and it steadfastly continues to maintain that this statement was true. Conceding that the $10 million buy-back of its Penn Central commercial paper inventory could, when isolated from the business context, be interpreted to reflect negatively on its motives, Goldman, Sachs insists that there were sound business reasons for this transaction which had nothing to do with a loss of faith in the Company's paper. With regard to the NCO "Prime" rating, Goldman, Sachs argues that it had no reason to believe that the rating was not based on NCO's independent evaluation of the paper. As for the other alleged omissions, the defendant maintains that they were for a variety of reasons not material in the circumstances of this transaction.

The action was tried to the court without a jury. In addition to six full days of testimony the parties submitted numerous depositions and portions of the testimony in one of the related cases, *Franklin Savings Bank v. Levy, et al.*, 406 F.Supp. 40 (S.D. N.Y.1975). (*Hereinafter F.S.B. v. Levy.*) In order properly to evaluate the respective contentions of the parties it is necessary, in addition to discussing the facts of the sale here in issue, to describe the workings of the commercial paper market, Goldman, Sachs' role in that market as an exclusive dealer, and the interaction between Penn Central and Goldman, Sachs in the months preceding the sale.

I.

A. The Parties

The Foundation is a California non-profit corporation based in Los Angeles, primarily engaged in raising funds for Loyola University. In March, 1970, and for about two years prior to that time, Howard B. Fitzpatrick, an industrial paint contractor, served as the Foundation's President. He donated ten hours a week to the Foundation, where he had sole responsibility for its daily affairs and for its investments. The Foundation's only employee was a part-time secretary.

From time to time Fitzpatrick decided to purchase commercial paper for the Foundation. These investments were made through one of the Foundation's several banks. When contemplating such a transaction, it was his practice to contact the investment department of at least two banks, find out what paper was available and select the item which best fitted the Foundation's requirements in terms of safety, rate of return and maturity. (106) (Unless otherwise indicated, numbers appearing in parentheses refer to pages of the trial transcript.) He then communicated this decision to one of the banks, which handled the actual purchase of the paper. One of the institutions so employed by Fitzpatrick was the Union Bank of Los Angeles. The official there with whom he dealt was Noel G. LeMay, Vice President in charge of the short-term money market operations of the bank's investment division.

Goldman, Sachs is a partnership in the business of investment banking, underwriting, securities brokerage and related financial activities. Its principal office is in New York City and it maintains offices in Los Angeles as well as other major cities. Since its inception in 1869 Goldman, Sachs has been a dealer in commercial paper. At the time of the transaction in issue, Goldman, Sachs was the largest of six such dealers.[3] The partner in charge of the Commercial Paper Department was Robert G. Wilson. Wilson was responsible both for the daily buying and selling operations and for the decision to accept or terminate corporate clients who wished to issue commercial paper. This decision hinged in large part on Wilson's assessment of the financial condi-

3. In early 1970 there was approximately $40 billion worth of outstanding notes in the entire commercial paper market, about $25 billion of which was sold directly by the issuing companies and $15 billion was sold via dealers. Goldman, Sachs handled 45% of all "dealer paper." (236–37)

tion of the issuer, or its c[illegible]hiness, a term dealt with extensively bel[illegible]. In making an evaluation of creditw[illegible]chiness Wilson placed heavy reliance on Jack A. Vogel, the Manager of the Credit Department, a sub-unit of the Commercial Paper Department. Vogel supervised the work of five credit analysts whose function was to assist in the initial investigation of prospective issuers, to monitor the financial condition of the issuers w[illegible]se paper Goldman, Sachs sold and to put together information of credit significance for periodic distribution to commercial paper purchasers.

B. The Commercial Paper Market and the Sale to the Foundation

The commercial paper market facilitates the flow of cash from lenders with temporary surpluses to borrowers with temporary deficits. Commercial paper consists of unsecured promissory notes usually having a maturity which does not exceed nine months. Corporations of sufficient size and reputation to attract purchasers of these general obligations can normally sell their paper at rates which enable them to meet their short-term borrowing requirements for less than they would have to pay for bank loans. The notes are sold on a discount basis and offer attractive short-term investment for corporations and others with substantial temporary cash excesses. The excesses must be substantial because paper is available only in large dollar units. (The average transaction involves $1 million (237), and in Penn Central's case, a $100,000. note was a small sale. (See Defendant's Exhibit CU.))

Because of the large amounts involved buyers understandably desire to complete the transaction on the date of the sale to avoid losing a day's interest, (260–61) and since the actual mechanics of delivering the notes to the buyer's bank are somewhat cumbersome, the selling day is compressed into a two-and-a-half to three hour period from roughly 9:30 A.M. to 12:00 or 12:15 P.M. During this period the sales force at Goldman, Sachs alone puts together four to five hundred transactions, (274) virtually all of which are completed in a series of brief telephone conversations between the purchaser, the purchaser's agent, if he has one, a commercial paper salesman and a commercial paper buyer.

The transaction involved in this case was typical. (274) Fitzpatrick knew that the Foundation had a $600,000. investment about to mature in an account at Union Bank. He called LeMay to inquire what commercial paper was available with a maturity of approximately six months as a successor investment. LeMay, in turn, called several commercial paper dealers, including the salesmen at Goldman, Sachs' Los Angeles office, to ask what paper was for sale. (14–15) The Goldman, Sachs salesman mentioned three or four issues which met Fitzpatrick's requirements, called a commercial paper buyer in his department to verify that the notes were still on hand and then confirmed to LeMay that the paper was in fact available for sale. (253–55, 274) LeMay at that point reported back to Fitzpatrick and the latter, recognizing Penn Central as a "huge industrial company" and assuming it to be "as safe as the United State Government" (113) elected to take the Company's notes. Accordingly, LeMay placed the order with Goldman, Sachs. Just as Goldman, Sachs' salesmen were answering numerous calls, LeMay also was dealing with as many as a hundred inquiries from bank customers in the three hour selling period. (35) Each of the phone conversations was therefore short and to the point, lasting from thirty seconds to no more than several minutes.

Due to the compressed and somewhat hectic nature of the selling day, it is not the practice for salesmen to engage in lengthy discussions with prospective buyers regarding the financial status of the various issuers. Like securities salesmen everywhere, in the brief time available, they may communicate such information as they possess about their current stock and endeavor to answer specific queries with regard to particular facts of an issuer's financial condition. To assist them in this task the salesmen have ready access to various sum-

maries of credit information prepared by Goldman, Sachs' Credit Department designated respectively white sheets, yellow sheets and green sheets.[4] During the period in which these notes were sold the salesmen were informed daily by their superiors which particular issues were in plentiful supply in the Goldman, Sachs inventory. Because it was costly to maintain inventory, see 888–889 *infra*, the sales force was encouraged to make a strong effort to sell these issues. (267–70; Defendant's Exhibit DX. And see Frederickson Deposition, 39–41; Coleman Deposition 33–36)

If a prospective investor desires to base his decision on a detailed analysis of the soundness of a particular issuer, he must acquire the information and perform the analysis himself. Many large institutions which regularly invest in commercial paper follow this practice and maintain constantly revised approved lists which are strictly observed. Other investors choose to rely on what are thought to be ready indices of creditworthiness, such as a "Prime" rating by the NCO, a division of Dun & Bradstreet, or the percent of outstanding paper an issuer has covered with bank lines. (Bank lines are open lines of credit to be made available to pay off maturing paper in the event that the company is unable to so by other means. They are discussed more detail below.) Still other investors rely exclusively on the good name of the dealer from whom they buy in the belief that the decision of a reputable dealer to sell the paper of a particular issuer is sufficient evidence of reliability of the security.

Apart from the return rate and maturity date, Fitzpatrick's sole criteria in selecting paper was safety. Accordingly, he had a clear understanding with LeMay that he was only interested in "quality" paper. He always insisted that the paper he bought be "prime", and he used the word in the "lay" sense. (109–10, 132) The instruction to LeMay, insofar as it resulted only in the purchase of paper rated "Prime" by the NCO, was unnecessary, because it was the policy of the Union Bank when buying for customers' accounts only to purchase "Prime" rated paper unless specifically instructed to the contrary by the customer. (5, 8, 29) Apart from the requirement of a "Prime" rating, however, LeMay relied entirely on the dealers' reputation in purchasing on behalf of customers. He was aware that Goldman, Sachs had a credit department which investigated issuers and he knew the defendant to be a "quality house." (65) So long as it was NCO prime, what was "good enough for Goldman, Sachs was good enough" for him. (67–69) The Goldman, Sachs salesmen with whom LeMay dealt knew, or were at least generally aware, that he was only interested in "Prime" rated paper. (8; see Coleman Deposition 112–14; Frederickson Deposition 91–92) On the date of the sale in question, LeMay asked no questions and sought no assurances about the Penn Central paper other than to note that it was NCO "Prime."

C. Penn Central's Relationship with Goldman, Sachs

In February, 1968, the Pennsylvania Railroad merged with the New York Central Railroad to form the Penn Central Company.[5] The merged entity was the largest transportation company in the world. In

4. A white sheet contains a duplication of the issuer's annual reports for the two previous years. The yellow sheet provides general information about the issuer including a brief description of its business, certain key financial and sales data and a listing of its important banks. Yellow sheets are prepared annually, and supplemented as necessary by green sheets which provide news of important interim developments. Some investors request this data prior to purchasing a company's paper. The sheets are in any event sent along with the confirmation to all buyers. (251–53)

5. In October, 1969 the Company became the Penn Central Transportation Company, a wholly owned subsidiary of the newly-formed Penn Central Company, which was a publicly held holding company. Unless specific reference is made to the holding company, Penn Central as used in this opinion refers to the pre-October, 1969 entity of that name and its subsequent incarnation, The Penn Central Transportation Company, which was the issuer of the commercial paper.

addition to its vast railroad properties, the Company had extensive holdings in real estate, and its total assets were valued at more than six billion dollars. The two constituent companies had a history of financial difficulties and it was anticipated that the merger would facilitate a recovery by enabling substantial economies and providing a base for a broad diversification program. However, although hope for the future was high, it was generally expected that it would be several years before the trend of losses in the railroad business would be reversed.

Early in 1968, as part of the Company's plan to finance cash needs in the early years of its new life, Penn Central sought and obtained ICC approval to issue $100 million of commercial paper, and approached Goldman, Sachs, which had sold paper for the New York Central, to act as its dealer. Prior to accepting the Penn Central account Goldman, Sachs performed a credit analysis to assure that the Company was creditworthy, which is to say that it had the capacity to pay the notes as they matured. Essentially, such an analysis requires examination of a company's access to cash in the near future either through anticipated earnings, lines of bank credit, anticipated long-term financing or assets which can be readily pledged or sold. (554–55; 565–70; 857)

In view of the extraordinary size and complexity of the merged corporation, and also of the fact that it was an untried entity comprised of two very troubled organizations, Vogel assumed primary responsibility for the analysis himself. (556–57) From time to time over a period of months he reviewed the available data on the Company, including press reports, published financial services, Company applications to the ICC, applications and filings with the SEC, annual reports from prior years, information from Goldman, Sachs' Research Department and other broker-dealers, lists of the Company's banks and lines of available credit and information obtained from contacts with Penn Central management by people at Goldman, Sachs. (481–82) On the basis of Vogel's review, he and Wilson agreed that Penn Central had ample resources to pay its debts and Goldman, Sachs agreed to act as the exclusive dealer in the Company's paper, which became available on August 1, 1968. The following March, the ICC approved Penn Central's request to sell another $50 million of paper for a period through September, 1969.

By the Fall of 1969 both Penn Central and Goldman, Sachs were experiencing certain problems which created a faint tension in their generally amicable business relationship. It was a period of rising interest rates and access to credit was increasingly difficult. This created problems for the management of Penn Central, whose task it was to raise money to finance the deficits which the Company continued to experience at a time when many of its assets were already heavily encumbered. After an encouraging record in 1968, the first two quarters of 1969 showed marked reversals.[6] The Company's cash position was tight, it had a deficit working capital position and its losses were increasing.

In mid-September 1969, Wilson and Vogel met with John O'Herron, Penn Central's new Vice President for Finance, and several other Company officials. The meeting was held at Wilson's request after learning of

6. The first quarter figures showed a 66% decline in consolidated earnings from the equivalent period of the previous year; for the first quarter of 1968 consolidated earnings were $13.4 million (58 cents a share), and for the first quarter of 1969, consolidated earnings were $4.6 million (19 cents a share). First quarter results for the parent railroad company showed a net loss of $12.8 million, as compared with a profit of $1.0 million for the similar period of the previous year.

The second quarter consolidated earnings were $21.9 million (91 cents a share), down 7.5% from $23.6 million ($1.03 a share) the previous year. The parent railroad company showed a net loss of $8.2 million, compared with 1968 second quarter earnings of $2.0 million. For the first half year, consolidated earnings declined from $37.0 million in 1968 to $26.5 million in 1969, and the net income of the parent railroad company declined from earnings of $3.0 million in 1968 to a loss of $21.0 million in 1969.

the Company's decision to seek ICC approval to continue to keep out the additional $50 million commercial paper and to authorize a second $50 million increase as well, a decision apparently motivated by the increased demand for cash. Before agreeing that such an increase was wise Wilson wished to review the Company's financial position and plans with O'Herron to satisfy himself that the added float of paper would not be an overextension of the Company's resources.

Among the topics of discussion was bank line coverage of the Company's paper. At the time, the Company had $100 million of bank lines, that is, open lines of credit available to meet maturities of commercial paper in the event that new sales were inadequate to do so, to cover its $150 million of commercial paper outstanding. O'Herron announced his intention to continue his coverage at the $100 million level after the outstandings increased to $200 million. Wilson suggested that investors were looking at bank line coverage as a guide to purchasing decisions and inquired whether O'Herron could increase the coverage by $50 million. O'Herron responded that he could, but because of the expense involved[7] he preferred not to, and he argued that there was no reason to require such an increase in view of the Company's other sources of available cash should it ever be required. Wilson accepted the response, agreeing for the time that in terms of safety there was no need to increase the lines, but stating that he would report back to the Company on any market resistance which might be caused by the 50% line coverage. O'Herron added that the Company's cash position through the 1st quarter of 1970 would be very tight and asked Goldman, Sachs to keep out as much paper as possible until April or longer. (858–63) (Plaintiff's Exhibit 20; Plaintiff's Exhibit 35)

The problem which was developing for Goldman, Sachs in the Fall and Winter of 1969–70, stemmed from its traditional mode of doing business. Historically it had always operated its commercial paper business on an "inventory" basis, purchasing whatever amount of notes an issuer-customer wished to sell in a given period, reselling them as a principal and retaining the unsold excess in its own inventory. (275) The practice provided Goldman, Sachs with a stock of paper of varying maturities and interest rates available for immediate delivery and additionally provided an important banking or underwriting service to issuers, assuring them of a desired level of outstandings and advancing them cash on the unsold notes. (275; Defendant's Trial Memorandum 21–22)

As interest rates steadily increased, however, the cost of doing business in this fashion became a serious concern to Wilson and his colleagues in the commercial paper department. Investors were able to bargain for precisely the maturity dates they desired and for better rates of interest, and the inventory of pre-set notes often went unsold in favor of notes sold on a "special order" and "tap issue" basis.[8] In order to sell notes which accumulated in inventory, Goldman, Sachs often found it necessary to lower the price, i. e., to increase the rate of return, often selling at a lower figure than it initially paid the issuer. This practice is called "distress selling." (276–77; 304) In addition to the problem of distress sales, the defendant also experienced what it termed a "negative carry" cost on the inventory, which refers to the difference between the rate of interest Goldman, Sachs was forced

7. In order to obtain open lines of credit a company is required to have compensatory balances of from 10 to 20% of the line on deposit with the bank. (246–47; Defendant's Exhibit CL; O'Herron Deposition, May 8, 1973, 7–9) The arrangement ties up the money and precludes realization of interest which might otherwise be earned, thus entailing significant costs.

8. In special order and tap issue sales the purchaser specifies his exact requirements and Goldman, Sachs communicates this information to the issuer. The issuer then writes a note tailored to the buyer's demand and delivers it to Goldman, Sachs, which in turn delivers it to the investor on the same day. (254–55) Even in these sales Goldman, Sachs purchases the notes from the issuer and resells them as a principal.

to pay to finance the inventory and the often lower rate of interest it received on the notes themselves. (276; 687–89) As a result of these expenses, the management committee of Goldman, Sachs imposed a limit of $250 million on the total amount of paper the commercial paper department was allowed to inventory at any one time. (690–91) This, in turn, created a constant pressure on Wilson to reduce the inventory of issuers with large inventory positions. (881)

Penn Central was one of the issuers which frequently was high on Goldman, Sachs' inventory list. (See Defendant's Exhibit CW) Throughout the Fall, Wilson continued to encourage the Company to increase its bank line coverage in an effort to enhance the saleability of the notes, and the Company continued to resist the suggestion. O'Herron's feeling was that 50% coverage was perfectly adequate and normal, that increased lines would be too expensive and that in view of the heavily financed condition of the Company he preferred not to ask the banks for additional credit at that time. He desired instead to raise money through the Company's highly profitable non-railroad subsidiary, the Pennsylvania Company, (Pennco), until long-term financing could be arranged. (O'Herron Deposition, May, 1973, 48) (And see 443; 894)

On October 20th, Penn Central's third-quarter earnings were announced, and they reflected a continued deterioration. For the first time the Company reported a consolidated loss, which was $8.9 million (as compared to earnings of $15.2 million for the third-quarter of 1963), and the parent railroad lost $19.2 million (compared to a $3.8 million loss for the same period in the previous year). Consolidated earnings for the first nine months were $17.6 million, down from $52.2 million, and the railroad showed a loss for the year so far of $40.2 million, against a 1968 nine month loss of only $747,000. These figures were widely reported in the financial press. Two days later, O'Herron spoke to Wilson on the phone and assured him that the fourth quarter figures would be "'in the black' with good improvement," saying that the ICC was expected to approve the additional $50 million in commercial paper imminently. (Plaintiff's Exhibit 33) Authorization finally was granted in early November,[9] and by December 1, the Company had obtained $200 million in "outstandings." ($21.85 million of which was in Goldman, Sachs' inventory!) (Defendant's Exhibit CW at 21) Throughout this month Wilson pressed O'Herron to increase the bank lines, informing him of market resistance to the notes in view of the continued negative financial news.[10]

By December, Goldman, Sachs introduced a new element into the discussions. Alarmed at the size of its Penn Central inventory Wilson suggested to O'Herron that at least $15 million of the back up lines should be converted to demand or "swing

9. In approving the increase the I.C.C. cautioned that:

> "Applicant feels that long-term financing the the present time is not feasible due to the tight money situation. Although we are sympathetic to applicant's problem, short-term financing has traditionally been relied upon to finance short-term needs and is not normally regarded as a proper source for long-term financing of capital expenditures or for refinancing of maturing long-term debt. As of June 30, 1969, applicant had a deficit working capital situation which can be expected to worsen if reliance on short-term financing is increased. The exhaustion of short-term credit to refinance maturing long-term debt or to finance long-term capital expenditures could expose a carrier to a serious crisis in the event of an economic squeeze, at which time a carrier may require short-term financing for traditional use. We are, therefore, concerned about the use of short-term financing for long-term purposes and feel that where necessary it should be resorted to cautiously.
>
> On the whole applicant is in a strong financial condition and in view of the present tight money market and applicant's stated intent to negotiate long-term financing as soon as it is feasible, we conclude that the application should be approved. . . ." 336 I.C.C. 1, 4 (October 29, 1969) (Plaintiff's Exhibit 64)

10. In November the papers carried reports of the testimony of Penn Central's counsel before agency hearings in Washington to the effect that the merged railroad was having serious difficulties, as well as reports that the Company had eliminated its fourth quarter dividend.

lines." These are bank lines available to the Company on short notice to cover its cash needs in lieu of unsold commercial paper. (323–32) Such lines would provide an alternative way to meet the Company's cash requirements above the amount of paper it was able to sell and would relieve pressure on Goldman, Sachs to fill this function by taking unsold paper into its inventory. At a meeting on December 9th, representatives from Goldman, Sachs made clear their concern over the size of the inventory, suggested again that the conversion to swing lines be effected and reiterated to Penn Central that there were buyers who looked for 100% bank line coverage. Although Goldman, Sachs continued to agree that this was not necessary from the point of view of safety, or creditworthiness, Wilson felt that it would substantially enhance the marketability of the Penn Central paper. (Plaintiff's Exhibit 22) The Company persisted in its resistance to the added expense of increased bank lines. It did agree, however, that Goldman, Sachs was bearing an unfair burden in maintaining such substantial inventories, and on December 24, 1969 the Company bought back from Goldman, Sachs $16 million of its paper, reducing Goldman, Sachs' inventory to almost nothing. The Company used part of the proceeds from a $50 million Penneo debenture offering to effectuate this repurchase.

Despite this temporary relief, the defendant's inventory of Penn Central notes began to climb again, when, in early January, 1970, at the Company's request Goldman, Sachs agreed to return to their prior arrangement, with the defendant buying as much paper as the Company asked it to and stocking the unsold portion in its inventory. (310–11) By mid-January Penn Central inventory was again in the $12–15 million range. (Defendant's Exhibit CW at 24)

Such was the state of events when, on February 4, 1970, the Company announced its fourth quarter and preliminary year end earnings. Contrary to O'Herron's prediction, the fourth quarter figures showed a $13.2 million consolidated loss. For the entire year the Company earned only $4.4 million, compared to $87 million in '68, and the railroad lost $56 million, ten times more than it lost the previous year. (Defendant's Exhibit A, 182)

Reaction at Goldman, Sachs was immediate. On the evening of the 4th, Wilson, who was surprised and unsettled by the announcement (988), telephoned the firm's senior partner, Gustave Levy, who was in St. Louis on business, and told him the bad news. Levy, who was the firm's contact with the top echelons of Penn Central, agreed to set up a meeting with David Bevan, the Company's Executive Vice President and chief financial officer, and O'Herron to discuss the significance of the latest figures. The meeting was arranged for February 6th.

In the meantime, on the 5th, Wilson and O'Herron discussed the situation by phone. O'Herron did his best to smooth over the latest figures, set out his anticipation of the Company's cash needs for the coming year, and reported on their plans to obtain long-term financing to begin to solidify the Company's condition. Wilson expressed irritation that he had not been given advance notice of the news, "as we are going to need a story to tell existing holders . . . and new purchasers." (Plaintiff's Exhibit 11) He warned of a large run off of the paper in the wake of the announcement, reiterated his suggestion to get 100% bank lines and intimated that although Goldman, Sachs would be willing to continue selling the paper, it might decide to do so only on a "tap issue" or non-inventory basis. In addition, at Wilson's request, O'Herron agreed to buy back $10 million worth of Goldman, Sachs' inventory on the following Monday, February 9th. (See Plaintiff's Exhibit 11)

It was also on the 5th that Goldman, Sachs began to get indications of adverse investor reaction to the news. Through one of its salesmen it learned that Brown Brothers, Harriman & Co., a banking institution which had in the past purchased up to 15% of outstanding Penn Central paper, had removed the Company from its approved list. Moreover, Jack Vogel received

a telephone call from Alan Rogers, the Senior Analyst at NCO, inquiring about Goldman, Sachs' reaction to the February 4th announcement. Vogel wrote a brief memorandum, or blue sheet,[11] on the conversation with Rogers, as follows:

"Alan Rogers of NCO called me today to express concern over the sharply reduced earnings announced in the newspapers today. He asked if we were continuing to sell the Company's notes and whether I felt that Penn Central had sufficient resources which could be converted to cash to pay down debt, if necessary. I said that Goldman, Sachs was continuing to sell the commercial paper notes of Penn Central Transportation Company. In answer to question number 2, I suggested that the Company has a number of valuable properties and securities, and that I was certain that something could be worked out should it ever become necessary.

Alan said that as a result of my comments, he would continue to carry Penn Central Transportation Company as a prime name."

On February 6th, Wilson and Levy met with Bevan, O'Herron, and Robert Loder, the Company's Treasurer and discussed the recently reported losses, the Company's plans to reverse the trend in the year ahead and the commercial paper situation. Levy and Wilson were satisfied with the explanation of the unexpected 4th quarter losses, which was that the accountants had at the last minute recommended extra charges of $16 million for snow removal and self-insured equipment. (Plaintiff's Exhibit 12) Moreover, they remained convinced that the Company was essentially sound and had the capacity to regain its financial footing. They were impressed by Bevan and O'Herron's plans to meet the Company's anticipated cash needs for 1970 and to obtain long-term financing within the coming months.[12] With regard to the commercial paper, they again raised the question of 100% line coverage, expressed the view that there would be a runoff of $50–$100 million and encouraged the Company to convert $50 million of their existing lines to swing lines to cover the consequent cash shortages. They also announced that they intended to impose a $5 million limit on the amount of Penn Central paper they would inventory at any one time.

On February 9th the Company repurchased $10 million of paper from Goldman, Sachs' inventory and from that point on the inventory rarely exceeded the $5 million limit imposed at the February 6th meeting. (See Defendant's Exhibit CW at 26–30)

On March 13th, University Hill purchased two Penn Central notes in the transaction described above.

D. The On-going Credit Investigation

Substantial evidence was adduced at trial as to the nature and scope of Goldman, Sachs' credit investigation, conducted primarily by Vogel and Wilson, both prior to the issuance of Penn Central paper and throughout the period that the paper was sold. The staff of the credit department routinely collected all newly available information about the Company as it was released and kept it in the Company's credit file. (Defendant's Exhibit A) This thick file folder contains a range of documents such as annual reports, prospectuses, proxy statements, press releases, newspaper clippings and clippings from Moody's Transportation Manual, a service which provides detailed financial summaries on companies in the transportation field. From his conduct of the initial credit investigation, see 887 *supra*, Vogel was familiar with the

11. Blue sheets are internal Goldman, Sachs memoranda which contain reports of all personal or telephonic contacts with issuers. (263-64)

12. Including an anticipated $56 million loss, the Company estimated its 1970 cash need to be $226 million. As of February 6th, $150 million remained to be financed. Bevan and O'Herron stated that they planned a $100 million bond offering in the Penn Central Company as soon as possible and a second $50-100 million long-term financing through a subsidiary at some unspecified time later in the year. (902-905; Plaintiff's Exhibit 12)

Company's financial structure, its resources and obligations, and he maintained familiarity by reviewing the new additions to the credit file as they came in. (505) Although he sometimes performed written calculations to figure the impact of newly developed data on the company's creditworthiness, he often relied on rough approximations done in his head, and what notes he did make were thrown away. (505–06; 558–59) Accordingly, the credit file is barren of any systematic written analysis of the Company's condition from a point if view of creditworthiness. His testimony is that all his calculations were directed toward a determination of the Company's usable assets in excess of debt which were available, if need be, to raise cash to meet its obligations. At all times, according to Vogel, the value of such assets substantially exceeded the amount of outstanding commercial paper, providing what the defendant terms a credit "cushion." (See Appendix A, Defendant's Post-Trial Memorandum)

With Vogel's knowledge of the Company's condition as a fundamental base of information, Vogel and Wilson's on-going credit analysis relied largely on the frequent contacts with management by Wilson and other Goldman, Sachs personnel and on contact with other members of the financial community who had dealings with the Company. In this manner they were able to stay informed as to both management's assessment of and plans for dealing with the Company's problems and the financial community's assessment of and willingness to extend credit to the Company despite its problems. Throughout the period with which this suit is concerned Goldman, Sachs had a high regard for the men in charge of the Penn Central (748–53; 853–54), and found their explanations of the Company's difficulties and their plans to resolve them to be credible and feasible. (See, e.g., note 12, *supra*) Their opinion of management was shared by many (748–53; Sullivan testimony, *F.S.B. v. Levy*, 874–75) and, indeed, many banking institutions continued to extend credit to the company. (See, e.g., 547–48; Plaintiff's Exhibit 23)

The conclusion Wilson drew from these contacts with management and other bankers and from Vogel's continuing determination that the Company's available assets greatly exceeded the amount of outstanding commercial paper was that Penn Central was at all relevant times creditworthy. It is important to note, however, that this conclusion was based entirely on the unchallenged representations of Company management and on data provided to the public by the Company. At no time did Goldman, Sachs ask Bevan or O'Herron to demonstrate a factual basis for their statements and predictions regarding the Company's condition. (895–99)

II.

A. The § 12(2) Claim

[1] For the Foundation to recover under § 12(2) of the Securities Act, it must establish that Goldman, Sachs made a false or misleading statement of material fact or omitted to state a material fact "necessary in order to make the statements, in the light of the circumstances under which they were made not misleading," that the Foundation did not know of the untruth or omission and that Goldman, Sachs knew, or in the exercise of reasonable care could have known, of the untruth or omission.[13] *Johns*

13. Section 12 of the Securities Act of 1933, provides that:

"Any person who—

* * * * * *

(2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him." 15 U.S.C. § 77*l* (1971).

Hopkins University v. Hutton, 422 F.2d 1124, 1128 (4th Cir. 1970). As distinct from a claim under Rule 10b-5, under § 12(2) the Foundation need prove neither *scienter* nor reliance, *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 689 (5th Cir. 1971); *Johns Hopkins University v. Hutton, supra*, 422 F.2d at 1129, but some causal relationship between the challenged communication and the sale must be shown. *Jackson v. Oppenheim*, 533 F.2d 826, 829–30 n. 8 (2d Cir. April 5, 1976).

[2] Although no express statements or representations were made to LeMay, (with the possible exception, noted below, that the paper was NCO "Prime"), both parties agree that in the context of this transaction there was some implicit representation as to the viability of the Penn Central notes. They disagree, however, precisely what the representation was.[14] We find that Goldman, Sachs impliedly represented that in its opinion, Penn Central was creditworthy. It represented also that there was a reasonable basis for this opinion, i.e., that a reasonable credit investigation had been conducted. See note 14, *supra*. We further find that, in the circumstances of this transaction, Goldman, Sachs represented the paper to be rated "Prime" by NCO. The evidence is unclear whether LeMay expressly requested that he only be shown "Prime" paper on the date of the sale, but we credit his testimony and that of at least one of the Goldman, Sachs salesmen, that it was generally understood that LeMay was only interested in "Prime" paper unless otherwise stated. (5–8; Coleman Deposition, 112–14; and see Frederickson Deposition 91–92)

The primary issue in the case is whether these three statements were false or misleading.

1. The Representation that Goldman, Sachs Believed Penn Central to be Creditworthy

a. The Alleged Falsity of the Claim

[3] A focus of attention in determining the truth or falsity of Goldman, Sachs' professed belief in the Company's creditworthiness is the $10 million buy-back arranged upon the February 4th announcement of the year-end financial report and consummated only five days later. The Foundation urges that this transaction is explicable only as a reflection that the defendant had lost confidence in the paper and was attempting to lighten its exposure in the event of disaster. We find, however, that the resale of the paper was not the result of such sinister machinations, but rather of honest business considerations and, further, that Goldman, Sachs did in good faith believe that the Company was creditworthy at the time of the sale here in issue.

Wilson and his colleagues in the commercial paper department were genuinely con-

Goldman, Sachs concedes the requisite use of interstate commerce in effectuating the sale to the Foundation. Regarding the limitation of the statute to statements made orally or in a prospectus, see note 19, *infra*.

14. The Foundation argues principally that there were two representations: 1) that Penn Central was creditworthy, and 2) that a reasonable credit investigation had been made. Goldman, Sachs maintains that there was only one representation, that it reasonably believed Penn Central to be creditworthy. The difference is largely one of semantics. The defendant's reference to "reasonable belief" interjects the issue of the reasonableness of the credit investigation, as it necessarily includes the concept that Goldman, Sachs had a reasonable basis for its opinion. This, in turn, carries with it the implication that a reasonable credit investigation was made. *Hanley v. Securities and Exchange Commission*, 415 F.2d 589, 597 (2d Cir. 1969). Jacobs, The Impact of Securities Exchange Act Rule 10b 5 on Broker-Dealers, 57 Cornell L.Rev. 869, 890 (July, 1972). (Hereinafter, Jacobs) Throughout this litigation Goldman Sachs has in effect conceded that it holds itself out as having made a reasonable investigation with regard to all commercial paper that it sells. (See, e.g., Weinberg Deposition, 41). With regard to the first representation, the only distinction of any significance between the two formulations is whether the statement of Penn Central's creditworthiness was one of fact or of opinion. We agree with the defendant that its sale of the notes can fairly be said to imply only a good faith opinion that the Company was creditworthy. To imply the factual statement that the Company is creditworthy, and to allow the Foundation to prevail by proving the falsity of the statement would border on making Goldman, Sachs an insurer of its issuers' soundness.

cerned throughout this period about the size and cost to Goldman, Sachs of carrying inventory and were making efforts to persuade issuers to obtain swing lines so that inventory could be reduced. Penn Central was not the only object of this campaign (313–15; Defendant's Exhibit BM), (although it may have been the only issuer which was explicitly informed of an inventory limit), and, contrary to the Foundation's assertion, several other issuers with consistently high inventories,—such as the Dow Chemical Company and AVCO Corporation—also repurchased substantial amounts of paper during the same period at Goldman, Sachs' request. (922–23; Defendant's Exhibits FL–FN)

Penn Central was a natural target for these efforts due to the size of the Goldman, Sachs inventories of Penn Central paper and the difficulties encountered in selling the paper. For months the Company had been resisting Goldman, Sachs' suggestions how to improve marketability but demonstrated no exceptional concern for the financial disadvantages of their relationship to Goldman, Sachs. The single buy-back on December 24th (obviously prior to the February 4th announcement) was, from Goldman, Sachs' point of view, a step in the right direction, but it was done without establishing an inventory limit, and the pressures of their relationship proved to be such that without a more-or-less formal understanding Goldman, Sachs again felt obliged in early January, 1970 to accommodate the Company's urgent need for cash.

The February buy-back and inventory limit represented a statement by Goldman, Sachs that although it was still willing to try to sell the paper, it was no longer willing to inventory it at considerable cost in the interest of accommodating a customer so unresponsive to its business advice. The February 4th announcement gave Wilson an opportunity to step up the pressure and he took it, at once reducing inventory, establishing a rough limit and pressuring the Company to reduce its dependance on the inventory method. The fact that he did so, however, is not inconsistent with his testimony that he never doubted the creditworthiness of the Company. To conclude otherwise would be to propose that simply because he genuinely believed that Penn Central would weather the storm he should have been willing to continue to bear the extra costs entailed in holding such an unusually large inventory, costs which he believed should properly be borne by the Company. That he later told O'Herron that the inventory limit would stand "until such time as they obtained 100% line coverage, completed some of these long-term financings, and started to reduce the operating losses" (Plaintiff's Exhibit 14) is, contrary to the Foundation's assertion, fully consistent with this interpretation of Wilson's behavior. As a salesman, his concern was for the marketability of his product, and he didn't plan to stock large quantities until convinced that it would sell well. His remark that he would "need a story to tell investors" was a sharp but casual rebuke to O'Herron for not having given him advance notice of the bad news, not the cynical comment of a conspirator against the investing public.

We find that based upon their perception of the Company's difficulties and its plans and capacity to deal with them, the men in charge at Goldman, Sachs did in good faith believe that the Company was creditworthy. We are not satisfied that there is reason to disbelieve the emphatic testimony on this point by Wilson, Vogel and Levy. One important matter which deserves particular mention in this regard is the testimony of Gustave Levy, Senior Partner of the firm, that as sole discretionary trustee in the "blind trust" of Walter Annenberg, then United States Ambassador to the Court of St. James and a close personal friend, Levy refrained, in or about November, 1969, from selling a substantial block of the Trust's Penn Central stock because of his view that it was underpriced. This decision was made at the very time when Levy was liquidating all other equity securities in the portfolio, including, for example, the stock of General Motors and Campbell Soup, because he believed that it was generally preferable to invest in debt instru-

ments in view of the condition of the market at that time. When Penn Central filed in bankruptcy, the stock was still held by the trust, causing a loss of several million dollars. (762–66; and see Defendant's Exhibits CB–CE) With due allowance for the different considerations entailed in dealing with commercial paper and equity securities, it is indeed difficult to believe that Levy would have acted as he did had he or his colleagues genuinely doubted the viability of the Company.[15]

b. The Alleged Omissions

[4] The Foundation also contends that the failure to disclose certain discrete facts, e. g., the unsuccessful efforts to convince the Company to increase bank lines, the removal of the notes from the approved list of Brown Brothers, Harriman, the facts of the post-February 4th buy-back, constituted material omissions which, "in light of the circumstances" rendered the statement made misleading or untrue. In considering this claim, one must view it in the context of the special circumstances of the transaction, which relate both to the nature of the commercial paper market as a whole and to LeMay's modus operandi within that market. Proof at trial demonstrated that for reasons relating to economics and practicalities peculiar to commercial paper, sales are made by way of hurried phone calls in which there is little or no expectation of unsolicited disclosure of the numerous facts always available as to an issuer's condition. Moreover, it is plain that whatever course other purchasers may have taken, such as inquiring into bank line coverage, LeMay sought no information whatsoever. Apart from ascertaining that the paper was prime, (with which we deal separately) he sought only a judgment of creditworthiness and chose to rely on it.

In a slightly different but parallel context the court in *Phillips v. Reynolds & Co.*, 297 F.Supp. 736 (E.D.Pa.1969) refused to hold a broker liable for failure to inform the plaintiff of a particular negative fact about the corporation whose stock he sold, where the evidence showed that the plaintiff sought only the broker's investment judgment. The court reasoned that:

> "[the buyer] admitted that he was relying on [the defendants'] judgment and opinion. [The defendant] did in fact accurately represent his opinion of [the issuer] . . . [The buyer] never requested any financial information concerning [the issuer], and made his own decision to risk nearly $60,000 after talking with [the defendant] on the telephone.
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> * * * * * *
>
> "[The buyer] was an experienced businessman who had made significant profits on [the defendant's] advice in the past and who chose to risk significant amounts after hearing a brief discussion on the telephone.
>
> * * * * * *
>
> "'To make a broker liable under these circumstances would make him a virtual insurer of his investment recommendations unless he provided customers with every conceivable material fact concerning a stock before customers purchased . . .'" *Phillips v. Reynolds & Co.*, 297 F.Supp. at 738, (citing earlier opinion in same case, 294 F.Supp. 1249).

This statement is singularly applicable to the facts at hand.

[5] It follows that none of the alleged omissions can be considered necessary "in light of the circumstances" unless the omitted facts, of themselves, rendered a judgment that the Company was creditworthy

15. We are, of course, aware that our determination that Goldman, Sachs acted in the good faith belief that the Company was creditworthy is contrary to the conclusion reached by Judge Metzner in *F.S.B. v. Levy, supra*, D.C., 406 F.Supp. 40 (1975). It is important to note that the record in this case contains substantial and persuasive evidence of the defendant's good faith which was not before the court in the prior action. We refer, in particular, to proof regarding returns of inventory to issuers other than Penn Central, like AVCO and Dow Chemical, and Levy's action as trustee of the Annenberg Trust. See Defendant's Memorandum in Support of Motion Pursuant to Rules 52(b) and 59(a), Federal Rules of Civil Procedure, submitted in *F.S.B. v. Levy, supra*.

unreasonable. For the following reasons we find that this is not true of any of the alleged omissions here.

With regard to the non-disclosure of the $10 million buy-back on February 9th, this conclusion is implicit in our determination that the transaction was motivated by legitimate business considerations and not by a loss of faith in the paper. The non-disclosure of the unsuccessful efforts to see that the Company raised bank line coverage to 100% would be actionable only if this was motivated by doubts as to creditworthiness. We are persuaded, however, that Wilson's campaign to convince O'Herron to obtain more lines was motivated by Wilson's concern for the marketability of the notes. Although this obviously indicates that in the minds of many investors at the time 100% coverage was an important index of creditworthiness, to the analysts at Goldman, Sachs it was far from determinative of this condition, since there were many other factors bearing on the ability and/or the desire of the Company to increase the coverage. (511–16) Similarly, while the facts 1) that Brown Brothers, Harriman removed the notes from its approved list, 2) that the Company was in a tight cash position with increasing losses and 3) that the ICC had expressed concern that the proceeds from the sale of paper were not being used to finance current transactions, are all relevant to a judgment of creditworthiness, none of them singularly or in the aggregate can be said to be necessarily conclusive of the judgment.

2. The Representation That the Paper was "Prime"

[6] The analysis of the *Phillips* court does not apply to the claims of the Foundation that the defendant failed to disclose that the "Prime" rating was based solely on Goldman, Sachs' decision to continue sales. If the rating service actually abdicated its independent judgment as to the quality of the Penn Central paper, or if Goldman, Sachs was so informed, a failure to qualify the representation that the paper was NCO "Prime" accordingly would clearly constitute a material omission "necessary under the circumstances." The proof at trial fails to establish, however, that NCO's "Prime" rating was based exclusively on Goldman, Sachs' statement that it would continue to sell the paper or that Goldman, Sachs had reason to believe that this was the case.

The evidence in support of the Foundation's contention consists of references in two internal Goldman, Sachs memoranda, by Vogel and Wilson respectively, to Vogel's conversation with Alan Rogers of NCO on February 5th. Vogel's blue sheet of that date, set forth in full above, indicates that Rogers, disturbed by the previous day's negative financial reports, called to obtain Vogel's reaction to the news. Contrary to the Foundation's assertion, the memorandum simply does not indicate that Rogers premised the continued prime rating solely on Goldman, Sachs' determination to continue sales. It states only that, "[A]s a result of my comments [i. e. that Vogel was confident of the Company's ability to meet maturities and that Goldman, Sachs would go on selling the notes] he would continue to carry Penn Central Transportation Company as a prime name." At most, this establishes that, in addition to the defendant's plans to market the notes, Rogers based his rating decision upon Vogel's statement that he continued to believe that the Company was creditworthy because it had sufficient resources to raise money to pay down debt as the need arose.

There is no basis to presume that Rogers' consultation with Vogel represented an abdication of Rogers' responsibility to render an independent judgment of the Company's condition. It was normal for Rogers, a long-time professional acquaintance of Vogel, to call Vogel to exchange views on credit matters, both as to Goldman, Sachs issuers and general market conditions. No inference of irresponsibility can be drawn from the fact that Rogers sought Vogel's opinion of the Company's capacity to pay the notes when due. In fact, it would seem rather irresponsible for the rating service not to touch base with the exclusive dealer in this paper in the course of monitoring the

Company's status and attempting to evaluate the significance of the recent adverse news.

In the absence of additional evidence to support the inference the Foundation would have us draw, we are unwilling to read Rogers' casual remark to his friend Vogel that "as a result of my comments . . . he would continue to carry [the Company] as a prime name" with the literalness which might be accorded to an affidavit. The reasonable interpretation is that, in combination with everything else he knew about the Company, Vogel's continued belief in the Company's viability was sufficient and credible reassurance to Rogers that the paper was entitled to a "Prime" rating. Moreover, even if Rogers had based the decision solely on Vogel's expression of confidence, Goldman, Sachs would not be liable for failing to disclose it unless it knew or should have known that this was the case. There is nothing to indicate that Vogel understood Rogers' remark to convey such a message or that it was unreasonable for him to believe that Rogers' decision was an independent one. As we read Vogel's blue sheet of February 5th, it is not the damning document the Foundation claims it to be. In fact, it is not unreasonable to infer that had LeMay been shown a copy of this memo, he would have viewed it as an added assurance of the safety of the investment.

Wilson's blue sheet on the February 6th luncheon meeting with Levy, Bevan, O'Herron and Loder reports that, in discussing the problems relating to commercial paper, "I also explained Allen Rogers' conversation with Jack Vogel and that Allen's feeling was that as long as Goldman, Sachs was going to continue to handle Penn Central's c/p he would keep the 'Prime' rating." (Plaintiff's Exhibit 12) In reconciling the differences between Wilson's formulation of Roger's remarks and Vogel's, the latter's is entitled to the greater weight, since he was the direct participant in the conversation and Wilson was not. More importantly, Wilson's choice of words must be viewed in the context of the February 6th meeting. He was speaking to Company officials and trying to impress upon them the importance of accepting his advice about taking steps to improve the marketability of the notes. It was clearly in his best interests to raise the possibility of losing the prime rating if things continued to deteriorate and to suggest that Goldman, Sachs had a particularly strong input into the rating decision.

In sum, the preponderance of the credible evidence does not support the Foundation's claim that the "Prime" rating was based exclusively on the defendant's decision to continue sales or that Goldman, Sachs had reason to believe that this was the case.[16] Accordingly, Goldman, Sachs cannot be held liable for failure to advise LeMay of his conversation with Rogers.

3. *The Representation That a Reasonable Credit Investigation Had Been Made*

In order to determine the truth or falsity of Goldman, Sachs' representation that a reasonable credit investigation had been made it is first necessary to ascertain the standard of reasonableness by which the defendant is to be judged. We have found no cases expressly directed to this issue, but there is a body of law in related contexts from which certain principles may be fairly derived.

16. NCO's involvement in the rating and marketing of Penn Central notes was the exclusive focus of the trial in *Mallinckrodt Chemical Works v. Goldman, Sachs & Co., et al.*, 420 F.Supp. 231, 71 Civ. 1437 (CHT), another of the "commercial paper cases," see note 1, *supra*, in which Dun & Bradstreet, the parent organization of NCO, was joined as a defendant. The other defendants in that case settled before trial. In a detailed and persuasive opinion, Judge Tenney recently dismissed the complaint against Dun & Bradstreet, finding, *inter alia*, that the staff of NCO based its rating decision on its own independent analysis, which in part may have considered the fact that Goldman, Sachs continued to sell the paper. Memorandum Opinion, September 13, 1976, at 26-27. Judge Tenney's conclusions, which are based on much more extensive evidence on the point then presented in the record of this case, are consistent with and supportive of our finding above.

a. The Standard of Reasonableness

[7-9] As one facet of the so-called "shingle theory" [17] broker-dealers are required to have a reasonable basis for recommendations made to customers which, in turn, imposes an obligation to conduct a reasonable investigation of the security's issuer. *Hanley v. S.E.C.*, 415 F.2d 589, 597 (2d Cir. 1969); *Kahn v. S.E.C.*, 297 F.2d 112 (2d Cir.), *rev'g and remanding MacRobbins & Co., Inc.*, 40 S.E.C. 497 (1961). See generally, Jacobs, *supra*, note 14, at 883–97. The amount and nature of investigation required in this context is flexible, depending on the nature and strength of the recommendation and the role of the broker-dealer in the transaction, *Canizaro v. Kohlmeyer & Co.*, 370 F.Supp. 282, 289 and n. 6 (E.D.La. 1974), quoting Jacobs, *supra*, note 14 at 87, his knowledge of and relation to the issuer, *Levine v. S.E.C.*, 436 F.2d 88, 90 (2d Cir. 1971), and the size and stability of the issuing company. *Hanley v. S.E.C., supra*, 415 F.2d 589, 597. And see Jacobs, *supra*, note 14, at 888. There are thus no iron clad rules as to what a broker must do to meet his responsibility. In *Hanley, supra*, the court stated that:

> "A salesman may not rely blindly upon the issuer for information concerning a company, although the degree of independent investigation which must be made by a securities dealer will vary in each case. Securities issued by smaller companies of recent origin obviously require more thorough investigation." 415 F.2d at 597.

Subsequently, in *Levine v. S.E.C., supra*, 436 F.2d 88, the court indicated that except in unusual circumstances the obligation to investigate does not impose a duty of first hand verification.

> "[A]bsent actual knowledge or warning signals, a broker-dealer should not be under a duty to retain his own auditor to re-examine the books of every company, the stock of which he may be offering for sale . . . ." 436 F.2d at 90.

It reiterated that "each case must be decided on its own specific facts," *id.*, and held in that case that the broker's intimate knowledge and opportunity for knowledge of the issuer's affairs precluded him from relying exclusively on data released by the Company which he could easily have verified. Language in *Hanley*, a case brought under the rubric of Rule 10b–5, suggests that a somewhat greater showing of inadequate investigation and/or culpable mental state may be required in a civil action by a customer seeking damages for losses caused by reliance on the implied warranty than in disciplinary proceedings instituted by the S.E.C. 415 F.2d 596 and n. 13. However the applicability of this suggestion to a claim under § 12(2), a negligence statute, is questionable.

[10] A second relevant group of decisions involve civil suits by aggrieved investors against underwriters for failure to investigate statements made in registration materials filed pursuant to § 5 of the Securities Act, 15 U.S.C. § 77e. The obligation to inquire in these decisions does not derive from so subtle a source as the shingle theory, but rather is rooted in the express statutory language of § 11(b) of the Securities Act, 15 U.S.C. § 77k(b) that only by demonstrating that a "reasonable investigation" was made can an underwriter escape liability for misrepresentations in registration statements. These cases reflect an approach to the evaluation of the reasonableness of an underwriter's investigation similar to that of the broker-dealer cases, *supra*.[18] However, since an underwriter's

17. Under this doctrine, when a broker-dealer hangs out his shingle he implicitly represents that he will deal fairly with the public. 3 L. Loss, Securities Regulation 1483 (2d Ed. 1961). See *Charles Hughes & Co., Inc. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786, 64 S.Ct. 781, 88 L.Ed. 1077 (1944); *Brennan v. Midwestern Life Insurance Co.*, 286 F.Supp. 702, 707 (N.D.Ind.1968), *aff'd* 417 F.2d 147 (7th Cir. 1969), *cert. denied* 397 U.S. 922, 90 S.Ct. 1122, 25 L.Ed.2d 397 (1970). See generally, 3 L. Loss, Securities Regulation, *supra*, 1482–93.

18. In *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 (S.D.N.Y.1968), Judge McLean concluded that the duty of "reasonable investigation" imposed by § 11

relation to the issuer is more substantial than that of a broker-dealer and it plays a more central role in the marketing process, somewhat more is required of an underwriter than a broker-dealer to discharge its obligation to the investing public. In *Feit v. Leasco Data Processing Equipment Corp.*, 332 F.Supp. 544 (E.D.N.Y.1971) Judge Weinstein put it that:

". . . The courts must be particularly scrupulous in examining the conduct of underwriters since they are supposed to assume an opposing posture with respect to management. The average investor probably assumes that some issuers will lie, but he probably has somewhat more confidence in the average level of morality of an underwriter who has established a reputation for fair dealing. Judge McLean expressed the proper relationship between underwriters and management in *BarChris:*

'In a sense, the positions of the underwriter and the company's officers are adverse. It is not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving. They may be unduly enthusiastic.' *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643, 696 (S.D.N.Y.1968).

In light of this adverse position they must be expected to be alert to exaggerations and rosy outlooks and chary of all assurances by the issuer. Their duty is to the investing public under Section 11 as well as to their own self-interest and that duty cannot be taken lightly." 332 F.Supp. at 581.

He added, however, in keeping with the tendency in all of these cases to key the degree of inquiry required to the relationship with the issuer, that an underwriter "cannot, of course, be expected to possess the intimate knowledge of corporate affairs of inside directors, and their duty to investigate should be considered in light of their more limited access." 332 F.2d at 582.

On a similar analysis, although on a showing of culpability somewhat greater than negligence, failure to verify certain representations in a registration filed in regard to a prospective merger sufficed to render an underwriter liable to a competing offeror under § 14(e) of the Securities Exchange Act. 15 U.S.C. § 78n(e). *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 369–73 (2d Cir. 1973).

The case which is factually closest to the instant controversy is *Sanders v. John Nuveen & Co., Inc.*, 524 F.2d 1064 (7th Cir. 1975), *vacated and remanded*, 425 U.S. 929, 96 S.Ct. 1659, 48 L.Ed.2d 172 (1976). In *Sanders* the defendant commercial paper dealer was sued by holders of worthless notes for failure reasonably to investigate the issuer, Winter & Hirsch, Inc. (WH), which had collapsed upon the rather sudden discovery that for ten years the principals of WH and its accounting firm had engaged in a massive fraud and the firm was hopelessly insolvent. In an opinion by then Judge (now Mr. Justice) Stevens, the court affirmed the district court's finding that Nuveen was liable to its customers under Rule 10b–5 because it breached a duty to make reasonable inquiries and such inquiries would have uncovered the fraud. The district court concluded that Nuveen, having bought and sold virtually all of WH's commercial paper, acted as an underwriter of the notes and this finding was not contested on appeal. 524 F.2d 1067. In reliance on the analysis of the underwriter's function and obligation in securities transactions in *Escott, Feit* and *Chris-Craft, su-*

"must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of 'data presented' to them by the company. It should make no difference that this data is elicited by questions addressed to the company officer by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel." 283 F.Supp. 697.

pra, Judge Stevens held that it was insufficient for Nuveen to have relied on published information about WH without attempting to verify the data. He noted that such reliance would satisfy a broker's duties under *Hanley, supra*, but that "a greater quantity of information is 'reasonably ascertainable' by an underwriter than by a mere broker, and something more than published data must be analyzed if an underwriter is to discharge his duty of investigation." 524 F.2d 1071.

[11] The *vacatur* and remand of *Sanders* for reconsideration in light of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976) casts serious doubt on the continued validity of the holding that, absent *scienter*, mere breach of duty to investigate where compliance would have revealed a fraud can give rise to liability under Rule 10b–5. Judge Stevens' discussion of what constitutes reasonable investigation retains relevance to this case, however, where liability is premised on an alleged false representation that the investigation was reasonable under § 12(2), a statute which requires no showing of *scienter*.[19] Moreover, both *Sanders* and *Chris-Craft*, brought under Sections 10(b) and 14 of the '34 Act respectively, refute Goldman, Sachs' assertion that "the status of underwriter has significance in terms of civil liability only under Section 11." (Defendant's Post-Trial Memorandum, p. 122)

[12] On the other hand we do agree that there are significant distinctions between the task of investigating or verifying specific factual representations in a particular registration statement or prospectus, which was the focus of the court's attention in *Chris-Craft* and the § 11 cases, and pursuing an on-going, judgmental determination such as "creditworthiness." Accordingly, it would be inappropriate to import wholesale to the commercial paper context the duties imposed under § 11. Nor would it be proper to read Judge Stevens' language in *Sanders* as establishing an inflexible rule that an investigation which fails to include first hand verification of an issuer's financial condition is *per se* unreasonable. Rather, in keeping with the approach of all the "reasonable investigation" cases discussed above, what is required is a close consideration of the facts of the relationship between Penn Central and Goldman, Sachs, the latter's access to information, the nature of the data it relied upon and the presence or absence of "warning signals", *Levine v. S.E.C., supra*, 436 F.2d [illegible], to Goldman, Sachs that something more might be in order.

b. *The Reasonableness of Goldman, Sachs' Credit Investigation*

[13] Based on the role it played in marketing Penn Central notes, Goldman, Sachs' credit investigation must be judged by a fairly rigorous standard. There can be no serious question that in buying virtually all of the paper issued by the company, distributing it to investors and taking the unsold portions into its inventory it functioned as an underwriter both as that term is defined in the Securities Act[20] and as commonly understood in the American financial com-

19. The trial court in *Sanders* dismissed a § 12(2) claim for reasons which are not entirely clear from the Circuit Court's opinion. See *Sanders, supra*, 524 F.2d at 1069 and n. 11. It appears that the decision was based on a determination that no prospectus was involved in the sale. *Id.* The statute only applies to sales effectuated by false or misleading oral statements or statements made in a prospectus. See note 13, *supra*. The sale in this case was effectuated by means of oral communications between Goldman, Sachs' salesmen and LeMay and those communications embodied the implicit representations alleged to be false. Our research has disclosed no relevant cases, but we perceive no reason why the statute should not apply to such facts. Indeed, the defendant has nowhere suggested that the § 12(2) claim is not properly asserted for this or any other reason.

20. Section 2(11) of the Securities Act, in pertinent part, defines an "underwriter" as

> "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . . ."

15 U.S.C. § 77b(11). See generally, 1 L. Loss, Securities Regulation 547–57 (2d Ed. 1961).

munity.[21] Moreover, it singlehandedly directed the entire distribution campaign and was the exclusive source of the notes for all would-be purchasers. Not only was its relationship to the Penn Central management, therefore, uniquely close, but its implicit warrant of the soundness of its basis for recommending the notes was correspondingly far greater than that of an ordinary broker-dealer. See *Canizaro v. Kohlmeyer & Co., supra*, 370 F.Supp. 282, 289 (E.D.La.1974) ("The brokers' obligation to his customer to investigate . . . must surely increase in direct proportion to the degree of his participation in the sale.")

[14, 15] With full allowance for Goldman, Sachs' obligations under the circumstances, however, we cannot agree with the Foundation that the entire credit investigation was unreasonable because it was based simply upon publicly available information and the unverified representations of management. As is clear from the foregoing discussion, we do not believe that the law imposes such an arbitrary measure by which a credit investigation may be judged. Moreover, there are important distinctions between relying on unsubstantiated figures or statements provided directly by the Company and relying on certified figures and statements in such documents as annual reports, offering circulars, government filings and industry-wide information services, all of which—individually and even more so in the aggregate—attain cumulative aspects of reliability. It would be unreasonable to require commercial paper dealers to conduct far-reaching, first hand verification of all issuing companies, no matter how strong the indications of financial well-being, and thereby to provide all disappointed purchasers with a cause of action against the dealer for failure to do so. (Our findings below are based solely on the particular facts of this case.) Neither can we agree that the somewhat casual manner in which the credit review was conducted alone warrants a finding of unreasonableness. While the record amply supports the conclusion that the analysis of the Company's financial resources was conducted largely inside Vogel's head, and the absence of a single comprehensive written evaluation of the Company's creditworthiness is, to a lawyer certainly, noteworthy, there is no evidence to suggest that such informal procedures in conjunction with regular contacts with management could under no circumstances suffice to keep a dealer adequately informed of an issuer's strength. Goldman, Sachs' credit file on Penn Central contains a substantial collection of relevant data with which Vogel was at least generally familiar, and his sense of the margin by which the value of assets available to raise cash exceeded the amount of outstanding commercial paper, the so-called credit cushion, appears to have been generally accurate.

Nevertheless, the defense asserted by Goldman, Sachs in support of its credit investigation is unacceptable. Throughout the case the defendant has argued that in the conduct of its ongoing credit review it simply never had reason to doubt the Company's viability. When queried by the court as to what kind of information he could have received which would have alerted him to the impending debacle, Wilson responded essentially that he could think of none because the Company had ample resources to raise cash up to the very end and management at all times spoke credibly and reassuringly of their options for reversing the downward trend. (937–38) In fact, defense witnesses maintained that Penn Central's collapse was a financially unnecessary event, caused by a failure of will or imagination on the part of management upon the government's unexpected refusal to extend a loan to the Company to cover for the last-minute withdrawal of a large debenture offering. (See 759–60) Necessarily implicit in this line of defense is the breathtaking proposition that so far as Goldman, Sachs could reasonably ascertain, the Company was actually creditworthy up to the bitter end. The argument proves too much. While our findings in no sense depend upon it, one may nevertheless fairly

21. See generally, 1 L. Loss, Securities Regulation, *supra*, 163–64.

ask whether the defendant's procedures and standards for monitoring the creditworthiness of an issuer might not almost be said to be *prima facie* inadequate if it is possible that such a presumably sound company as Penn Central could go bankrupt without the prior knowledge of, or even without a hint to Goldman, Sachs, its exclusive dealer in commercial paper.

[16] The question, however, is not whether Goldman, Sachs conducted a reasonable credit investigation in May or June, 1970, but whether by March 13, 1970, the date of the Foundation's purchase, there were sufficient storm warnings as to the Company's insecure condition to render Goldman, Sachs' normal procedures inadequate and to require more concrete verification of management representations and projections. We conclude that such cause existed at least upon the disclosure of the 1969 fourth quarter and year end figures in early February, 1970. At that point there were surely enough signs that the Company was in serious financial straits to render the defendant's exclusive reliance on publicly available data and the unverified representations of management inadequate to meet its obligation to the investing public. Its failure to inquire more closely into the basis for the statements of Bevan and O'Herron at the February 6th meeting, to require access to Company records and projections, to verify them or more aggressively to consult with other financial institutions which dealt with the Company for their appraisal of the Company's position, rendered Goldman, Sachs' ongoing credit investigation unreasonable, and its representation to the Foundation untrue within the meaning of § 12(2).

Consideration of the reasonableness of Goldman, Sachs' response to the February 4th announcement begins with the fact that Penn Central was from the start an atypical issuing company which faced particularly adverse circumstances throughout the Fall and Winter of 1969–70. Vogel, himself, recognized that Penn Central, being the product of a merger of two financially bedeviled railroads, was a "very unique credit." (556–57) [22] The Company's entire commercial paper program was motivated in large part by the need to raise cash to finance long-term expenditures and refinance long-term debt. This untraditional use of short-term financing was required because substantial earnings were not anticipated in the first several years of the Company's existence while economies were to be achieved. In approving the final increase in commercial paper from $150 to $200 million, the ICC, in October, 1969 expressed concern about this unusual use of commercial paper and warned that the tactic "could expose [the Company] to a serious crisis in the event of an economic squeeze." (see note 9, *supra*) It was understood that the Company's future depended heavily on its ability to obtain long-term financing in the fairly near future, see *id.*, which made the existence of thorough, realistic plans for such financing an absolute necessity. Successful financing, in turn, depended in large part on public confidence in the prospect of successful operations—or at least future operations—giving added gravity to negative financial news which received wide publicity throughout this period. See, e. g., note 10, *supra*. It thus seems clear that there was particular reason for Goldman, Sachs to be concerned about unanticipated adverse developments in the Company's financial posture. Despite its undoubted capacity on paper to absorb large losses, there was a point at which public confidence might be so shattered that the vital refinancing could not be accomplished. Wilson himself persistently voiced his fear of a runoff in the commercial paper outstandings due to a loss of investor interest in the notes as the bad news mounted. And the generally negative market conditions which prevailed for long-term as well as short-term financing dictated even greater cau-

22. Indeed, it was the absence of a track record of earnings and performance and the expectation that it would be several years before significant earnings would be realized which necessitated his focus on the Company's saleable or pledgeable assets to determine its creditworthiness. (Tr. 477–78; 556–57).

tion as to the Company's optimistic plans for refinancing. (See, e. g., Defendant's Exhibit FJ).

Goldman, Sachs' repeated claim that throughout this period of financial hardship it had no reason to doubt the dependability and candor of Company management in their dealings with each other is not supported by the record. It was well understood at Goldman, Sachs that the Company was under particular strain. It was also clear to Wilson that due in large part to the strain an adversary element had entered into their relationship, as a result of which management was not being entirely forthcoming in regard to its ability to obtain additional bank line coverage. In fact, the relations between the two firms during this period as described by Goldman, Sachs' own witnesses was one which alone renders its uncritical acceptance of Company representations open to question. The lack of candor was not limited to the sparring over bank lines, moreover. According to Wilson's blue sheet of October 22, 1969, O'Herron indicated to him in a phone conversation that the Company would "show a small loss in the 3rd quarter, but anticipate[d] the 4th quarter will be 'in the black' with a good improvement." (Plaintiff's Exhibit 33) In fact, the 3rd quarter figures, which had actually been released the previous day, reflected a loss for the Company on a consolidated basis of $8.9 million and a loss for the parent railroad of $19.2 million. This was the Company's first consolidated loss and the largest reported loss for the parent railroad to date, see note 6, *supra*, bringing its loss for the year to a total of $40.2 million. O'Herron's characterization of these figures as a "small loss" appears at best to have been disingenuous. His assurances that the 4th quarter would be in the black, concededly a more speculative proposition, again proved to be way off the mark. The consolidated loss for this period was $13.2 million, and for the railroad alone $16 million, bringing the year-end total to $56 million. Moreover, to Wilson's irritation, O'Herron did not even see fit to give him any advance notice of the negative report despite its marked divergence from O'Herron's earlier prediction.

Wilson and Levy were chargeable not only with knowledge of these facts when they set out for the February 6th luncheon meeting with Bevan, O'Herron and Loder, but also with knowledge that indications of serious adverse investor reaction had already developed. We have dealt at length above with Alan Rogers' call to Vogel to "express concern" over the latest reports. Although it is of course true that Vogel satisfied Rogers that the Company remained creditworthy, the very fact that the call was made nevertheless was an indication, if any was needed, that the news could cause severe negative reaction among investors. More important, Goldman, Sachs also knew that Brown Brothers, Harriman, a highly respected banking institution which had in the past held up to 15% of Penn Central's outstanding commercial paper, had removed the Company from its approved list.

All of these factors combine to render the defendant's uncritical acceptance of Bevan's forecasts and projections at the February 6th luncheon meeting and the complete absence of any effort to confirm that there was some factual basis for them a failure of reasonable ongoing credit investigation. Bearing in mind the Company's fundamental dependence on sales of commercial paper, the power struggle which had developed over the means of marketing the notes, the lack of candor on the part of management in previous months and the negative financial developments throughout the same period, the description of the issuer-underwriter relationship in *Escott v. BarChris Constr. Corp., supra*, note 17, has a singularly poignant ring:

> "It is not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving. They may be unduly enthusiastic." 283 F.Supp. at 696–97.

In fact, Bevan predicted that railroad losses for the year 1970 would again be $56 million, i. e., that the situation had bottomed. In April, however, the Company

reported a gargantuan $62.7 million railroad loss for the first quarter alone, and a consolidated loss of $17.2 million, a development which signalled the beginning of the end. Had the defendant requested copies of the Company's projected first quarter earnings as they were revised on a bi-weekly basis it would have seen that from mid-February through early March the enormity of the 1st quarter results was foreseen. (Plaintiff's Exhibit 101–03) Similarly, if defense witnesses are correct that the bankruptcy was triggered by a lack of adequate contingency planning, inquiry would have revealed the situation. What is perhaps most striking, in light of the continuous series of reported railroad losses in the previous year, is the total absence of inquiry into railroad operations, which were at once the Achilles' heel and the *sine qua non* of success. There is no reason to doubt that the Company would have provided this kind of information to Goldman, Sachs at this juncture in view of its dependence on the commercial paper market, and in turn, on Goldman, Sachs, for survival until long-term financing could be arranged. Moreover, the record is plain that Goldman, Sachs had easy access to the opinions of other members of the financial community, so that it could readily have inquired of Brown Brothers, Harriman as to the reasons it had removed the Company from its approved list. (831) Had it made anything more than a superficial inquiry into the circumstances surrounding a $50 million bridge loan obtained through Pennco at the end of February, it could probably also have learned that the First National City Bank, the Company's single largest lender, had declined to participate in the loan because of reservations about the continued heavy use of the relatively profitable subsidiary to channel money to the ailing railroad. (See Sullivan Testimony *F. S. B. v. Levy*, 889–90; 898–903; and see Plaintiff's Exhibit 106; Defendant's Exhibit AD; Defendant's Exhibit A–84) The main point, however, is not what Goldman, Sachs would have learned but what it should have done to discharge its duty reasonably to inquire and to render its representation that it did so investigate true.[23]

Although we credit Goldman, Sachs' assertion that it acted at all times in the good faith belief that the Company was creditworthy, by early February, 1970 it had reason to be far more cautious and inquisitive than it was. By that time there were enough danger signals that an aggressive skepticism was in order regarding the cheery predictions and projections of management. As the underwriter and exclusive dealer in these securities Goldman, Sachs had important obligations to the investing public to put Company management to the test and make them demonstrate a realistic basis for their optimism. It lost sight of these responsibilities, however. Perhaps more accurately it was unduly confident that an entity with the size and resources of Penn Central, like the Titanic, could not go under. Indeed, one comes away from this case with the ironic impression that the analysts at Goldman, Sachs and many of their colleagues in the financial community made the same fatal assumption made by Fitzpatrick, who instinctively felt that an investment in a company as large as the Penn Central was as safe as the United States Government.

[17, 18] The remaining elements of § 12(2) liability may be treated briefly.

23. If Goldman, Sachs' credit investigation had been reasonable it would not be liable to the Foundation even if it remained convinced that the Company was creditworthy, unless what it learned was sufficient to render an opinion of creditworthiness itself unreasonable. Since it is uncertain precisely what information a reasonable investigation would have revealed, it is impossible to state whether Goldman, Sachs would have been liable under the latter theory had it adequately inquired and yet continued to market the paper. In view of the enormity of the continuing 1st quarter losses and the increasingly bleak market conditions for long-term financing (see Defendant's Exhibit FJ), however, a court might well conclude that a continued belief in the creditworthiness of the Company would have been unreasonable. Despite the defendant's efforts to minimize the significance of the huge losses, there is at least some testimony that they were indeed a significant cause of the Company's demise. (813).

The materiality of the false representation that a reasonable credit investigation had been conducted, i. e., that a reasonable commercial paper investor would attach importance to the representation in making his investment decision, *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811, 86 S.Ct. 23, 15 L.Ed.2d 60 (1965), or that there is a "substantial likelihood" that such is the case, *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976), is apparent from the reliance so many investors placed on the identity of the dealer of a particular issue. The materiality of this representation is not contested by the defendant. It is also plain that the Foundation did not know of the untruth, and that it was causally related to the sale. See *Jackson v. Oppenheim, supra*, 533 F.2d 826, 830 n. 8. Finally, the defendant has not sustained its burden of proof that it could not reasonably have known of the falsity of its representation.

B. Rule 10b-5, State Law and Common Law Claims

[19] Our finding that Goldman, Sachs acted at all times in good faith forecloses recovery under § 10(b) or Rule 10b-5. *Ernst & Ernst v. Hochfelder, supra*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976).

It is not necessary to determine the Foundation's additional claims. Having established a violation of § 12(2) it is entitled to rescind the sale and it is academic whether a case has also been made out under the asserted alternative bases of liability as well.

For the reasons set forth above, the Foundation is entitled to rescind the purchase and recover the consideration paid for the notes plus interest from the date of the sale.

The foregoing constitutes our findings of fact and conclusion of law.

Submit judgment on notice.